

S. Hrg. 108-473

**U.S. TAX SHELTER INDUSTRY: THE ROLE OF
ACCOUNTANTS, LAWYERS, AND FINANCIAL
PROFESSIONALS**

HEARINGS

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON

GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 18 AND 20, 2003

VOLUME 4 OF 4

Printed for the use of the Committee on Governmental Affairs



**U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS,
LAWYERS, AND FINANCIAL PROFESSIONALS**

S. Hrg. 108-473

U.S. TAX SHELTER INDUSTRY: THE ROLE OF ACCOUNTANTS, LAWYERS, AND FINANCIAL PROFESSIONALS

HEARINGS

BEFORE THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

OF THE
COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

NOVEMBER 18 AND 20, 2003

VOLUME 4 OF 4

Printed for the use of the Committee on Governmental Affairs



U.S. GOVERNMENT PRINTING OFFICE

94-086 PDF

WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

COMMITTEE ON GOVERNMENTAL AFFAIRS

SUSAN M. COLLINS, Maine, *Chairman*

TED STEVENS, Alaska	JOSEPH I. LIEBERMAN, Connecticut
GEORGE V. VOINOVICH, Ohio	CARL LEVIN, Michigan
NORM COLEMAN, Minnesota	DANIEL K. AKAKA, Hawaii
ARLEN SPECTER, Pennsylvania	RICHARD J. DURBIN, Illinois
ROBERT F. BENNETT, Utah	THOMAS R. CARPER, Delaware
PETER G. FITZGERALD, Illinois	MARK DAYTON, Minnesota
JOHN E. SUNUNU, New Hampshire	FRANK LAUTENBERG, New Jersey
RICHARD C. SHELBY, Alabama	MARK PRYOR, Arkansas

MICHAEL D. BOPP, *Staff Director and Chief Counsel*

JOYCE A. RECHTSCHAFFEN, *Minority Staff Director and Counsel*

AMY B. NEWHOUSE, *Chief Clerk*

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

NORM COLEMAN, Minnesota, *Chairman*

TED STEVENS, Alaska	CARL LEVIN, Michigan
GEORGE V. VOINOVICH, Ohio	DANIEL K. AKAKA, Hawaii
ARLEN SPECTER, Pennsylvania	RICHARD J. DURBIN, Illinois
ROBERT F. BENNETT, Utah	THOMAS R. CARPER, Delaware
PETER G. FITZGERALD, Illinois	MARK DAYTON, Minnesota
JOHN E. SUNUNU, New Hampshire	FRANK LAUTENBERG, New Jersey
RICHARD C. SHELBY, Alabama	MARK PRYOR, Arkansas

RAYMOND V. SHEPHERD, III, *Staff Director and Chief Counsel*

ELISE J. BEAN, *Minority Staff Director and Chief Counsel*

ROBERT L. ROACH, *Minority Counsel and Chief Investigator*

MARY D. ROBERTSON, *Chief Clerk*

CONTENTS

Opening statements:	Page
Senator Coleman	1, 69
Senator Levin	4, 72
Senator Lautenberg	9

WITNESSES

TUESDAY, NOVEMBER 18, 2003

Debra S. Petersen, Tax Counsel IV, California Franchise Tax Board, Rancho Cordova, California	11
Mark T. Watson, former Partner, Washington National Tax, KPMG LLP, Washington, DC	13
Calvin H. Johnson, Andrews & Kurth Centennial Professor, The University of Texas at Austin School of Law, Austin, Texas	14
Philip Wiesner, Partner in Charge, Washington National Tax, Client Services, KPMG LLP, Washington, DC	32
Jeffrey Eischeid, Partner, Personal Financial Planning, KPMG LLP, Atlanta, Georgia	32
Richard Lawrence DeLap, Retired National Partner in Charge, Department of Professional Practice-Tax, KPMG LLP, Mountain View, California	34
Larry Manth, former West Area Partner in Charge, Stratecon, KPMG LLP, Los Angeles, California	34
Richard J. Berry, Senior Tax Partner, Pricewaterhouse Coopers, New York, New York	54
Mark A. Weinberger, Vice Chair, Tax Services, Ernst & Young LLP, Washington, DC	55
Richard H. Smith, Jr., Vice Chair, Tax Services, KPMG LLP, New York, New York	57

THURSDAY, NOVEMBER 20, 2003

Raymond J. Ruble, former Partner, Sidley Austin Brown and Wood, LLP, New York, New York, represented by Jack Hoffinger	76
Thomas R. Smith, Jr., Partner, Sidley Austin Brown and Wood, New York, New York	77
N. Jerold Cohen, Partner, Sutherland Asbill and Brennan, LLP, Atlanta, Georgia, accompanied by J.D. Fleming	79
William Boyle, former Vice President, Structured Finance Group, Deutsche Bank AG, New York, New York	95
Domenick DeGiorgio, former Vice President, Structured Finance, HVB America, Inc., New York, New York, accompanied by Brian Skarlatos	97
John Larson, Managing Director, Presidio Advisory Services, San Francisco, California	114
Jeffrey Greenstein, Chief Executive Officer, Quellos Group, LLC, formerly known as Quadra Advisors, LLC, Seattle, Washington	115
Mark Everson, Commissioner, Internal Revenue Service, Washington, DC	128
William J. McDonough, Chairman, Public Company Accounting Oversight Board, Washington, DC	130
Richard Spillenkothen, Director, Division of Banking Supervision and Regulation, The Federal Reserve, Washington, DC	131

IV

ALPHABETICAL LIST OF WITNESSES

	Page
Berry, Richard J.:	
Testimony	54
Prepared statement	303
Boyle, William:	
Testimony	95
Prepared statement with an attachment	317
Cohen, N. Jerold:	
Testimony	79
Letter dated November 18, 2003, submitted with answers to questions	315
DeGiorgio, Domenick:	
Testimony	97
Prepared statement	326
DeLap, Richard Lawrence:	
Testimony	34
Eischeid, Jeffrey:	
Testimony	32
Prepared statement	298
Everson, Mark:	
Testimony	128
Prepared statement with an attached chart	338
Greenstein, Jeffrey:	
Testimony	115
Prepared statement	334
Johnson, Calvin H.:	
Testimony	14
Prepared statement	286
Manth, Larry:	
Testimony	34
Larson, John:	
Testimony	114
McDonough, William J.:	
Testimony	130
Prepared statement	349
Petersen, Debra S.:	
Testimony	11
Prepared statement	275
Ruble, Raymond J.:	
Testimony	76
Smith, Richard H., Jr.:	
Testimony	57
Smith, Thomas R., Jr.:	
Testimony	77
Prepared statement	312
Spillenkotchen, Richard:	
Testimony	131
Prepared statement	361
Watson, Mark T.:	
Testimony	13
Prepared statement	285
Weinberger, Mark A.:	
Testimony	55
Prepared statement	309
Wiesner, Philip:	
Testimony	32

APPENDIX

Minority Staff Report of the Permanent Subcommittee on Investigations entitled, "U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals, Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2," released in conjunction with the Permanent Subcommittee on Investigations' hearings on November 18 and 20, 2003, S. Prt. 108-34	145
I. INTRODUCTION	145
II. FINDINGS	147
III. EXECUTIVE SUMMARY	149
A. Developing New Tax Products	151
B. Mass Marketing Tax Products	152
C. Implementing Tax Products	153
D. Avoiding Detection	157
E. Disregarding Professional Ethics	159
IV. RECOMMENDATIONS	160
V. OVERVIEW OF U.S. TAX SHELTER INDUSTRY	162
A. Summary of Current Law on Tax Shelters	162
B. U.S. Tax Shelter Industry and Professional Organizations	164
VI. FOUR KPMG CASE HISTORIES	166
A. KPMG In General	166
B. KPMG's Tax Shelter Activities	168
(1) Developing New Tax Products	172
(2) Mass Marketing Tax Products	188
(3) Implementing Tax Products	206
a. KPMG's Implementation Role	206
b. Role of Third Parties in Implementing KPMG Tax Products	215
(4) Avoiding Detection	235
(5) Disregarding Professional Ethics	245
APPENDIX A	
CASE STUDY OF BOND LINKED ISSUE PREMIUM STRUCTURE (BLIPS)	255
APPENDIX B	
CASE STUDY OF S-CORPORATION CHARITABLE CONTRIBUTION STRATEGY (SC2)	266
APPENDIX C	
OTHER KPMG INVESTIGATIONS OR ENFORCEMENT ACTIONS	270

EXHIBIT LIST

Page

Volume 1

1. a. <i>BLIPS: Bond Linked Issue Premium Structure</i> , PowerPoint presentation with eight slides prepared by the Permanent Subcommittee on Investigations	371
b. <i>SC²</i> , PowerPoint presentation with five slides prepared by the Permanent Subcommittee on Investigations	379
c. <i>Mass Marketing of Tax Shelters</i> , chart prepared by the Permanent Subcommittee on Investigations	384
d. <i>Knowledge of Counter Parties</i> , chart prepared by the Permanent Subcommittee on Investigations	385
2. KPMG Memorandum, February 1998, re: Summary and observations of OPIS	386
3. KPMG Memorandum, May 1998, re: <i>OPIS Tax Shelter Registration</i>	393
4. Gibson, Dunn & Crutcher LLP Memorandum to KPMG, March 2000, re: <i>BLIPS Tax Opinion</i>	400
5. KPMG email, April 1999, re: <i>BLIPS</i> (“The original intent of the parties was to participate in all three investment stages of the Investment Program.” It seems to me that this is a critical element of the entire analysis and should not be blithely assumed as a “fact”. If it is true, I think it should be one of the investor’s representations. However, I would caution that if there were, say, 50 separate investors and all 50 bailed out of at the completion of Stage I, such a representation would not seem credible.)	408
6. KPMG email, February 2000, re: <i>Product champions needed for S Corp strategy</i> (I want to personally thank everyone for their effort during the approval process of this strategy. It was completed very quickly and everyone demonstrated true teamwork. Thank you! Now lets SELL, SELL, SELL!!)	412
7. KPMG email, February 2000, re: <i>BLIPS/OPIS</i> (. . . the sooner we get them out the door the better since the law—especially the primary profit motive test—is evolving daily and not in a taxpayer friendly manner. * * * As I understand the facts, all 66 closed out by year-end and triggered the tax loss.)	415
8. KPMG email, February 2001, re: <i>SC2 Solution—New Development</i> (Quick Snapshot—We are now offering a modified SC2 solution. S Corp shareholders can use the structure of direct significant gift to 501(c)(3) tax exempts of their choice. Net tax benefit is less than original SC2 . . . shareholder “feel good” factor is higher. We need targets and ICV’s. * * * Look at the last partner scorecard. Unlike golf, a low number is not a good thing. . . . A lot of us need to put more revenue on the board before June 30. SC2 can do it for you. Think about targets in your area and call me.)	423
9. KPMG email, June 2000, re: <i>Revised SC2 Script</i> , Rosenthal/Stein approval of SC2 calling script	426
10. KPMG emails, September 1998, January 1999, and October 2000 re: Grantor Trust Issue and KPMG Memorandum of Telephone Call, May 2000, re: Grantor Trust Issue (So our best intelligence is that you are increasing your odds of being audited, not decreasing your odds by filing that Grantor Trust return. So we have discontinued doing that.)	428
11. KPMG email, March 1998, re: <i>Simon Says</i> (. . . and yet in truth the option was really illusory and stood out more like a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant.)	439
12. Email, May 1999, re: <i>Who is the Borrower in the BLIPS transaction</i> (Based on your analysis below, do you conclude that the tax results sought by the Investor are NOT “more likely than not” to be realized? * * * Yes.)	448

VII

	Page
13. Email, August 1999, re: <i>BLIPS (However, before engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT [Washington National Tax] partners remain skeptical that the tax results purportedly generated by a BLIPS transaction would actually be sustained by a court if challenged by the IRS.)</i>	450
14. KPMG email, May 1998, re: <i>OPIS Tax Shelter Registration (If for some reason the IRS decides to “get tough” with someone vis-a-vis the old rules, I suspect it could easily pick on ANY of the Big 6, or for that matter any number of law firms/promoters—I don’t think we want to create a competitive DISADVANTAGE, nor do we want to lead with our chin.)</i>	451
15. KPMG email, December 1998, re: <i>OPIS (After December 31, 1998, there will be no marketing of OPIS in any circumstances.)</i>	452
16. KPMG email, July 1999, re: <i>National Accounts Database (VALUE PROPOSITION: . . . The all-in cost of the program, assuming a complete loss of investment principal, is 7% of the targeted tax loss (pre-tax). The tax benefit of the investment program, which ranges from 20% to 45% of the targeted tax loss, will depend on the taxpayer’s effective tax rates. FEE: BLIPS is priced on a fixed fee basis which should approximate 1.25% of the tax loss. Note that this fee is included in the 7% described above.)</i>	453
17. KPMG email, August 1999, re: <i>BLIPs (Depicting the approval of BLIPS and views of some at KPMG about the strategy.)</i>	455
18. KPMG email, September 1999, re: <i>BLIPS 2000 (A number of people are looking at doing BLIPS transactions to generate Y2K losses. We currently have bank capacity to have \$1 billion of loans outstanding at 12/31/99. This translates into approximately \$400 million of premium. This tranche will be implemented on a first-come, first-served basis until we fill capacity. Get your signed engagement letters in!!)</i>	459
19. KPMG email, February 2000, re: <i>Hot Tax Products (5 Month Mission) (Thanks for help in this critically important matter. As Jeff [Stein] said, “We are dealing with ruthless execution—hand to hand combat—blocking and tackling.” Whatever the mixed metaphor, let’s just do it.)</i>	460
20. KPMG email, April 2000, re: <i>SC2 (There have been several successes—the West and South Florida with many ICV’s in other parts of the country. We are behind. This is THE STRATEGY that they expect significant value added fees by June 30. The heat is on. . . .)</i>	463
21. KPMG Document, SC ² — <i>Meeting Agenda June 19th, 2000</i>	464
22. KPMG email, July 2000, re: <i>Attaching memorandum to Tax Partners and Tax Management Group. re: Selling with Confidence: Skills for Successful Selling—“Positioning.”</i>	486
23. KPMG email, August 2000, re: <i>Solution Activity Reports—SC2 (Our team of telemarketers is particularly helpful in a number of respects: —to further qualify prospects; —to set up phone appointments for you and your deployment team.)</i>	488
24. KPMG email, November 2000, re: <i>SW SC2 Channel Conflict (Attached is a list of SC2 targets in the Southwest that we are including in an upcoming telemarketing program.)</i>	490
25. KPMG email, December 2000, re: <i>STRATECON WEST—KICK OFF PLAN FOR ’01 (. . . we must aggressively pursue these high-end strategies.)</i>	492
26. KPMG email, March 2001, re: <i>Friday’s Stratecon Call (Due to the significant push for year-end revenue, all West Regional Federal tax partners have been invited to join us on this call and we will discuss our “Quick Hit” strategies and targeting criteria.)</i>	494
27. KPMG email, April 2001, re: <i>Friday’s Stratecon Call (The [tax] strategies have a quick revenue hit for us, . . .)</i>	495

VIII

	Page
28. KPMG email, May 1999, re: <i>Marketing BLIPS (One does not need to understand how the program is structured to determine whether someone has sufficient gain and has the tax risk appetite to do an OPIS/BLIPS type strategy.)</i>	496
29. KPMG email, September 1999, re: <i>BLIPS—managing deal flow (As you know, we have until 10/15 at the latest to close loans and 10/22 to activate the FX trading etc. (the 60 day countdown).)</i>	499
30. KPMG email, October 1999, re: <i>BLIPS (18 OPIS “slots” were reserved for the intended BLIPS participants noted in the third paragraph below.)</i>	500
31. KPMG email, November 1999, re: <i>BLIPS (It occurs to me that it would be useful to know something about the investment performance as we call these clients to discuss their go forward strategy. . . . * * * As you may be aware, the 60-day anniversary of your client’s participation in the Strategic Investment Fund is November 22nd. As a reminder for you and your client, we have summarized certain procedures that may be of interest.)</i>	503
32. <i>Generating Capital Losses, A Presentation for ———, KPMG Peat Marwick LLP, ———, 1996</i>	505
33. KPMG Memorandum, June 1998, re: <i>June 11 OPIS Conference Call (Use of Nondisclosure Agreements and Outside Advisors)</i>	517
34. Email, July 1999, re: <i>BLIPS—Economic Substance Issue (Gentlemen, we have completed our review of the BLIPS loan documents. In general, these documents indicate that the loan proceeds will be invested in very safe investments (e.g., money market instruments). Thus it seems very unlikely that the rate of return on the investments purchased with the loan proceeds will equal or exceed the interest charged on the loan and the fees incurred by the borrower to secure the loan. * * * Before any fees are considered, the client would have to generate a 240% annual rate of return on the \$2.5 million foreign currencies investment in order to break even. If fees are considered, the necessary rate of return to break even will be even greater.)</i>	521
35. KPMG email, May 2000, re: <i>Brown & Wood BLIPS Opinion letters (As we discussed, the B&W opinion letters touch all the necessary bases. The fact and representation sections are almost identical to the ones in our Opinion and many analysis sections are exact copies of our Opinion. Please let me know if you want further details about the “non-critical” typos.)</i>	522
36. KPMG email, July 1999, re: <i>brown&wood (If you have a KPMG opinion, you should also have a B&W opinion. We do ours and they use it as a factual template for their opinion, usually within 48 hours.)</i>	524
37. <i>Internal Revenue Bulletin No. 2000–36, September 5, 2000, Notice 2000–44, Tax avoidance using artificially high basis—describing a BLIPS-type transaction</i>	525
38. KPMG Document, <i>PFP Practice Reorganization, Innovative Strategies Business Plan—DRAFT (May 18, 2001)</i>	528
39. KPMG email, May 1999, re: <i>BLIPS Update (Larry [DeLap], I don’t like this product and would prefer not to be associated with it.)</i>	532
40. KPMG email, December 2000, re: <i>Weekly Tax Solutions Call (Larry [DeLap]—Are you suggesting that we stop marketing the solution, or that you just don’t want a public discussion of the solution in light of the IRS focus?)</i>	533
41. KPMG’s Personal Financial Planning Presentation, <i>BLIPS AND TRACT, Carol Warley, June 1999 (BLIPS Benefit: —Avoid All Of The Capital Gains And Ordinary Income Tax; —Net Benefit To Client —Effective Tax Rate Less After Tax Cost of Transaction of Approximately 5%)</i>	536
42. KPMG email, April 1999, re: <i>BLIPS (The underlying tax planning is such that the investor is likely to bail out after Stage 1; i.e., after about 60 days.)</i>	543

IX

	Page
43. KPMG email, March 2000, re: <i>S-corp Product</i> (No, we don't disclose all risks in all engagement letters. * * * . . . I definately (sic) agree on disclosing the risks upfront and would prefer to have the separate memo that states the risks involved. . . . is there a way to make the risk memo be covered under 7525?)	545
44. Sutherland Asbill & Brennan LLP correspondence, July 2002, re: Representations of BLIPS client	555
45. KPMG correspondence to Sutherland, Asbill & Brennan LLP, September 2002, re: Contract with KPMG for tax assessment for BLIPS client	557
46. KPMG email, November 2002, re: <i>Script</i> (Attached is a list of law firms that are handling FLIP/OPIS cases. * * * Attached is the script . . . waiver language and list of attorneys to follow.)	560
47. KPMG email, March 2002, re: <i>SC2</i> (Given the current state of affairs relative to the IRS and accounting firms, I think we should not be discussing SC2 on the Monday night call at this time.)	563
48. KPMG email, August 1999, re: <i>BLIPS Engagement Letter</i> (Attached is the engagement letter approved by Larry [DeLap].)	566
49. KPMG email, March 2000, re: <i>S-corp Product</i> (1. This appears to be little more than a old give stock to charity and then redeem it play . . . * * * Our preference is that the client donate stock to a local 401(a), . . .)	574
50. KPMG email, April 2000, re: <i>S-Corporation Charitable Contribution Strategy (SC2)</i> (This is a relatively high risk strategy.)	584
51. KPMG email, August 2001, re: <i>New Solutions-WNT</i> [Washington National Tax] (Beginning in December . . . The shareholders will most likely want access to the cash (especially if we could get it to them tax-free).)	585
52. KPMG email, October 2001, re: <i>SC2 Client</i> (His ownership is so minute, he is concerned about it being reduced any further by the charitable contribution. We know that this reduction is only temporary, . . .)	587
53. KPMG Document, <i>Tax Innovation Center, Product Idea Submission Form</i> and <i>KPMG Tax Solution Alert</i> , April 24, 2000, <i>S-Corporation Charitable Contribution Strategy</i>	589
54. KPMG document, undated, <i>Draft PDC Talk Points 6/19, S-Corporation Charitable Contribution Strategy</i> (Cold call script.)	595
55. KPMG email, March 2001, re: <i>Florida S corporation search</i> (Request to utilize database on tax return information to identify potential SC2 clients.)	597
56. KPMG email, March 2001, re: <i>South Florida SC2 Year End Push</i>	599
57. KPMG email, March 2001, re: <i>SC2—Client Base Expansion</i>	601
58. KPMG email, December 2001, re: <i>SC2</i> (. . . working on a back-end solution to be approved by WNT [Washington National Tax] that will provide S-corp shareholders additional basis in their stock which will allow for the cash built-up inside of the S-corporation to be distributed tax-free to the shareholders.)	602
59. KPMG email, January 2002, re: <i>SC2</i> (Shelly Nance is in Fort Wayne, which is "cold call central". How can she (or he) be involved in sending out messages about SC2 if it is not being mass marketed.)	604
60. Permanent Subcommittee on Investigations correspondence to KPMG, LLP, November 2003, re: November hearing testimony	609
61. KPMG Presentation excerpts: <i>Tax Innovation Center Solution and Idea Development—Year-End Results</i> , May 30, 2001; and <i>Goal: Deposit 150 New Ideas in Tax Service Idea Bank</i>	612
62. KPMG Presentation excerpts: <i>Innovative Tax Solutions</i> , July 19, 2001; <i>Tax Practice Update</i> ; and <i>Tax Practice Growth Gross Revenue</i>	614
63. KPMG Presentation, <i>S-Corporation Charitable Contribution Strategy (SC2 Update)</i> , June 18, 2001, showing SC ² Revenues	617

	Page
64. KPMG email, May 1999, re: <i>BLIPS—More Likely Than Not?</i> (. . . while I am comfortable that WNT [Washington National Tax] did its job reviewing and analyzing the technical issues associated with BLIPS, based on the BLIPS meeting I attended on April 30 and May 1, I am not comfortable issuing a more-likely-than-not opinion letter wrt (sic) this product . . .)	621
65. KPMG email, May 1999, re: <i>BLIPS</i> (The real “rubber meets the road” will happen when the transaction is sold to investors, what the investors’ actual motive for investing the transaction is and how the transaction actually unfolds. * * * My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would review as falling squarely within the tax shelter orbit.)	623
66. KPMG email, August 1999, re: <i>BLIPS</i> involvement in the <i>NE—BDMs</i> (KPMG’s fee is 1.25% (125 basis points) of the gain to be mitigated. This fee is included as part of the 7% investment in strategy.)	628
67. Deutsche Bank email, July 1999, re: <i>Risk and Resources Committee Paper (BLIPS Summary—The 7.7% will cover market risks, transaction costs, and DBSI fees.)</i>	632
68. Email, September 1999, re: West (Larry [DeLap], just to clarify, even if we have five or more investors in a single <i>BLIPS</i> transaction, you don’t think we need to register the transaction as a tax shelter. Is this correct? * * * No, that is not correct, Mark Ely has concluded there is a reasonable basis not to register.)	641
69. Deutsche Bank/Presidio Advisors, LLC Memorandum, April 1999, re: <i>BLIPS</i> friction costs (On day 60, Investor exits partnership and unwinds all trades in partnership.)	644
70. Deutsche Bank New Product Committee Overview Memo: <i>BLIPS</i> Transaction (It is imperative that the transaction be wound up after 45–60 days and the loan repaid due to the fact that the <i>HNW</i> individual will not receive his/her capital loss (or tax benefit) until the transaction is wound up and the loan repaid.)	646
71. First Union (Wachovia) Capital Management Group Enhanced Investment Strategy Release, February 2, 1999	651
72. KPMG Foreign Leveraged Investment Program, Issue and Hazard Summary (Taxpayer not sufficiently “at risk” under section 465) (preliminary and final versions)	652
73. KPMG email, February 1999, re: <i>BLIPS</i> (. . . status of the <i>BLIPS</i> as an <i>OPIS</i> replacement strategy. . . . I would think we can reasonably anticipate “approval” in another month or so. * * * Given the marketplace potential of <i>BLIPS</i> , I think a month is far too long— . . .)	654
74. Email, February 1999, re: <i>BLIPS</i> Progress Report (I don’t like this pressure . . .)	655
75. KPMG <i>MEETING SUMMARY</i> , February 1999, re: <i>Determine if BLIPS is viable</i>	656
76. Email, April 1999, re: <i>BLIPS</i> (I would not characterize my assessment of the economic substances of the “premium borrowing” in the <i>BLIPS</i> transaction as “positive.”)	660
77. Email, April 1999, re: <i>BLIPS</i> Analysis	661
78. Email, May 1999, re: <i>Who is the Borrower in the BLIPS transaction</i>	662
79. Email, August 1999, re: <i>BLIPS</i> Documents—Acceptance of Recommended Language	663
80. Email, May 1999, re: <i>BLIPS</i> (According to Presidio, the probability of making a profit from this strategy is remote (possible, but remote).)	664

XI

	Page
81. KPMG email, May 1999, re: <i>BLIPS</i> (. . . my change in heart about <i>BLIPS</i> was based on information Presidio disclosed to me at a meeting on May 1. This information raised serious concerns in my mind about the viability of the transaction, and indicated that WNT [Washington National Tax] had not been given complete information about how the transaction would be structured . . .)	665
82. Email, August 1999, re: <i>BLIPS</i> (. . . before engagement letters are signed and revenue is collected, I feel it is important to again note that I and several other WNT [Washington National Tax] partners remain skeptical that the tax results . . . would actually be sustained by a court if challenged by the IRS.)	666
83. Email, January 2000, re: <i>BLIPS</i> 2000 (The PFP guys really need your help on the <i>BLIPS</i> 2000 strategy. . . so we can take this to market.)	667
84. Email, March 2000, re: <i>Blips I</i> , <i>Grandfathered Blips</i> , and <i>Blips 2000</i> (. . . I do not believe KPMG can reasonably issue a more-likely-than-not opinion on the economic substance issues for the <i>Blips</i> . . .)	668
85. KPMG Memoranda, February 1999, re: <i>BLIPS</i>	669
86. KPMG Memoranda, March 2000, re: <i>Talking points on significant tax issues for BLIPS 2000</i>	670
87. KPMG Memoranda, <i>S Corporation Charitable Contribution Strategy, Summary of Certain Risks</i> (The opinion also much be based on all pertinent facts and the law as it relates to those facts; must not be based upon inaccurate legal or factual assumptions; and must not unreasonably rely upon the representations, statements, findings, or agreements of the taxpayer or any other person.)	675
88. Email, May 1999, re: <i>BLIPS</i> (It was not until I heard conflicting information that I questioned the original facts. In the future, I will question everything Presidio and Randy Bickham represent to me.)	677
89. KPMG <i>Tax Leadership</i> , 2003; KPMG <i>Tax Practice Organization</i> , 2002, 2001 and 2000	680
90. a. KPMG Tax Opinion Letter (Signed Final), December 1999. [Redacted by the Permanent Subcommittee on Investigations]	684
b. Brown & Wood Tax Opinion Letter (Signed Final), December 1999. [Redacted by the Permanent Subcommittee on Investigations]	781
c. SEALED EXHIBIT: Unredacted copies of Exhibit No. 90a. and 90b (above)	*
91. KPMG Memoranda, August 1998, re: <i>Tax Products Practice</i> (I was responsible for KPMG's position that we should not register <i>OPIS</i> as a tax shelter and insisted that we make the business case with <i>DPP</i> . This was of significant benefit in marketing the <i>OPIS</i> product and will establish the direction with respect to KPMG's position on future tax products.)	857
92. KPMG email, September 1998, re: <i>OPIS</i> (These fees relate to approximately \$1.2 billion in notional losses for approximately 25 clients.)	865
93. Email, June 1998, re: <i>OPIS</i> (Not only will this unduely (sic) harm our ability to keep the product confidential, it will DESTROY any chance the client may have to avoid the step transaction doctrine.)	866

Volume 2

94. a.-ggg. Documents relating to <i>FLIP/OPIS</i>	869
95. a.-BBB. Documents relating to <i>BLIPS</i>	1240
96. a.-ll. Documents relating to <i>SC2</i>	1692

Volume 3

97. a.-pp. Documents relating to development/marketing of tax products	1951
98. a.-ppp. Documents relating to registering, reporting and filing with Internal Revenue Service	2225

XII

	Page
99. Documents relating to investment advisory firms:	
a.-f. Quadra/Quellos	2473
g.-t. Presidio	2485
100. Documents relating to law firms:	
a.-u. Sidley Austin Brown & Wood	2540
v.-gg. Sutherland Asbill & Brennan	2576
101. Quadra Capital Management, LP. facsimile, August 1996, <i>attaching Memorandum on UBS' involvement in U.S. Capital Loss Generation Scheme (the "CLG Scheme") (As I mentioned, KPMG approached us as to whether we could affect the security trades necessary to achieve the desired tax results.)</i>	2607
102. Deutsche Bank Memorandum, July 1999, re: <i>GCI Risk and Resources Committee—BLIPS Transaction</i>	2612
103. Deutsche Bank email, July 1999, re: <i>Risk & Resources Committee Paper—BLIPS and Comments on Blips Collateral and Credit Terms (I would have thought you could still ensure that the issues are highlighted by ensuring that the papers are prepared, and all discussion held, in a way which makes them legally privileged.)</i>	2615
104. Deutsche Bank email, July 1999, re: <i>Risk & Resources Committee Paper—BLIPS (Our approach is as follows: STRUCTURE: . . . Privilege (sic): This is not easy to achieve and therefore a more detailed description of the tax issues is not advisable. REPUTATION RISK: . . . we have been asked by the Tax Department not to create an audit trail in respect of the Bank's tax affairs.)</i>	2618
105. Deutsche Bank email, February 2002, re: <i>Updated Presidio/KPMG trades (I understand that we based our limitations on concerns regarding reputational risk which were heightened, in part, on the proportion of deals we have executed relative to the other banks. * * * . . . we would like to lend an amount of money to Hypovereinsbank equal to the amount of money Hypovereinsbank lends to the client.)</i>	2619
106. Deutsche Bank email, April 2002, re: <i>US GROUP 1 Pres, attaching Structured Transactions Group North America Presentation, November 15, 1999</i>	2622
107. HVB Document, undated, re: <i>Presidio (7% -> fee (equity) paid by investor for tax sheltering)</i>	2646
108. HVB email, September 1999, re: <i>Presidio</i>	2647
109. Deutsche Bank email, April 1999, re: <i>presidio—w. revisions (. . . The holding period/life of the LLC will typically be 45 to 60 days. At the end of this time period, the LLC will unwind all transactions, repay the loan par amount and premium amount. For tax and accounting purposes, repaying the premium amount will "count" like a loss for tax and accounting purposes.)</i>	2649
110. KPMG email, March 2000, re: <i>Bank representation (The bank has pushed back the loan again and said they simply will not represent that the large premium loan is consistent with industry standards.)</i>	2657
111. HVB credit request for BLIPS transaction by Presidio personnel, September 1999. <i>(HVB will earn a very attractive return if the deal runs to term. If, however, the advances are prepaid within 60 days (and there is a reasonable prospect that they will be), HVB will earn a return of 2.84% p.a. on the average balance of funds advanced.)</i>	2660
112. KPMG Memoranda, March 1998, re: <i>OPIS (The attached went to the entire working group. . . . I believe that the OPIS product ("Son of Flip") is a stripped down version of the LLC (partnership) structure.)</i>	2678

XIII

	Page
113. Deutsche Bank email, October 1999, re: <i>BLIPS</i> (PKS reports that a meeting with John Ross was held on August 3, 1999 in order to discuss the <i>BLIPS</i> product. PKS represented PB Management's views on reputational risk and client suitability. John Ross approved the product, however insisted that any customer found to be in litigation be excluded from the product, the product be limited to 25 customers and that a low profile be kept on these transactions.)	2679
114. Deutsche Bank New Product Committee Overview Memo: <i>BLIPS</i> Transaction (11-DB will have the right to approve/disapprove all trading activity in the Company. This will allow DB to effectively force the closure of the company and repayment of its loan to DB.) [Note: An alternative version of this document was previously entered into the Permanent Subcommittee on Investigations' hearing record as Exhibit No. 70.]	2681
115. KPMG Minutes of Assurance/Tax Professional Practice Meeting, September 28, 1998	2686
116. Brown & Wood email, December 1997, re: joint projects (This morning my managing partner, Tom Smith, approved Brown & Wood LLP working with the newly conformed tax products group at KPMG on a joint basis in which we would jointly develop and market tax products and jointly share in the fees, as you and I have discussed.)	2691
117. KPMG email, September 1997, re: <i>Flip Tax Opinion</i> (ALSO, OUR DEAL WITH BROWN AND WOOD IS THAT IF THERE NAME IS USED IN SELLING THE STRATEGY, THEY WILL GET A FEE.)	2692
118. KPMG Memorandum, March 1998, re: <i>B&W Meeting</i> (What should be the profit-split between KPMG, B&W and the tax products group/ implementor for jointly-developed products?)	2693
119. KPMG Memorandum, December 1997, re: <i>Business Model—Brown & Wood Strategic Alliance</i>	2696
120. Brown & Wood email, December 1997, re: <i>Confidential Matters</i> (On another point, as I have been mentioning with you, I do work for a number of people who have potentially complementary tax advantaged products. Let me state up front, I am not trying to push any of these on KPMG, but it might be useful if you are trying to get a repitroire of products jump started to talk to some or all of them. In addition, each of them has a relationship with one or more financial institutions who provide credit, derivatives trades, etc. necessary to execute the product.)	2699
121. KPMG email, May 2000, re: <i>BLIPS—7 percent</i> (The breakout for a typical deal is as follows: . . . Trading Loss 70 * * * Attached is Kerry's breakout of the 7 percent. [Redacted] gets 30 bpts from the Mgt. Fee. Is this detailed enough?)	2701
122. KPMG email, September 1999, re: <i>BLIPS—managing deal flow</i> (As you know, we have until 10/15 at the latest to close loans and 10/22 to activate the FX trading, etc. (the 60 day countdown).)	2702
123. HVB Memorandum, October 1999, re: <i>Presidio Credit Request Dated September 14, 1999</i> (To summarize the above, the increased limits will now permit the full amount of our facility to be invested in EUR deposits and do related forwards.)	2703
124. HVB Document, <i>Back-End Process</i>	2705
125. HVB Document, <i>Transaction Timeline</i> (Exchange USD Amount to EUR Amount * * * USD 181,300,000)	2711
126. PRESIDIO ADVISORY SERVICES, LLC Memorandum, April 2002, re: <i>Year 2000 Strategic Plan</i> . (Over the past two years because of delays in obtaining the requisite approvals to market the OPIS and BLIPS products, we did not begin closing deals until September of 1998 and 1999, respectively. * * * Both Deutsche Bank and KPMG have requested that we replace our existing BLIPS product with a new product in 2000.)	2712

XIV

	Page
127. KPMG/Presidio Advisors email, October 1999, re: <i>Couple of quick questions—Liquidating distributions (Upon distribution (at the end of the 60 day period), can the client designate where the funds go?)</i>	2719
128. Handwritten notes, March 1998, re: <i>Brown & Wood (Confirm w/Presidio that they will register.)</i>	2720
129. PRESIDIO ADVISORY SERVICES, LLC Memorandum, September 1999, re: <i>BLIPS loan test case (Four special purpose, single member Delaware LLC, owned by four trusts: D. Amir Makov revocable trust (1/3), JL capital trust (1/3), RP capital trust (1/6), pointe du Hoc irrevocable trust (1/6))</i>	2721
130. KPMG/Presidio Advisors email, December 1998, re: <i>BLIPS meeting (Second, the tax analyses and opinion writing needs to go into high gear.)</i>	2722
131. KPMG/Presidio Advisors/Brown & Wood email, December 1998, re: <i>BLIPS meeting (I spoke with R.J. this morning about a “tax-focused” meeting next week. As a first step before scheduling a meeting, we thought that we should first draft the base of an opinion letter in an outline format which will be circulated for comment before getting everyone together for a “all-hands” meeting. We are currently working on the document and expect to circulate it next week.)</i>	2723
132. KPMG email, February 2000, re: <i>Brown & Wood opinion letter—BLIPS (Jeff Eischeid has promised the Brown & Wood opinion template ready in two weeks and we need your analysis.)</i>	2724
133. KPMG email, January 2001, re: <i>blips (We’re still working with Moore & Van Allen. They’ve declined to write a concurring opinion—their firm doesn’t write such opinions as a matter of policy. They are considering, this week, whether they will write [redacted] a MLTN [More Likely than Not] penalty opinion.)</i>	2726
134. IRS Form 8264, Application for Registration of a Tax Shelter, QA Investments, LLC registration of FLIP	2727
135. KPMG/Quadra Fax and Memoranda, October 1997, re: Registration of FLIP	2729
136. Deutsche Bank email, July 1999, re: <i>hi bill..presidio (i informed him that you are point man on the deal and that all comments should go through you)</i>	2734
137. KPMG email and Memorandum, July 1997, re: <i>Revised Memorandum ((I) KPMG’s Tax Advantaged Transaction Practice; (II) Presidio’s Relationship with KPMG; (III) Transition Issues.)</i>	2735
138. HVB Document, August 2000, <i>Presidio—Plafond (Investors have, so far, chosen to liquidate before the second (180 day) phase. ie after 60 days.)</i> ...	2745
139. a.–t. Documents relating to Ernst & Young	2746
140. a.–o. Documents relating to PriceWaterhouseCoopers	2803
141. a.–k. Documents relating to First Union	2848
142. a. WNT Solutions by Primary Functional Group—FYI 2001–2002, November 26, 2002, reprinting first three pages of document (other pages sealed, see Exhibit 139b.)	2871
b. SEALED EXHIBIT: WNT Solutions by Primary Functional Group—FYI 2001–2002, dated November 26, 2002	*
143. SEALED EXHIBIT: StrateconWest email, December 2001, re: <i>StrateconWest/FSG Solution (Please find attached the latest and greatest list of strategies for StrateconWest and FSG)</i>	*
144. SEALED EXHIBIT: Correspondence between Brown & Wood LLP and Presidio Advisors LLC, dated October 1998 and February 1999, regarding billing and document preparation for tax opinion	*
145. Organizational Chart, <i>KPMG Tax Practice Organization</i> , produced by KPMG LLP in response to request made by Senator Levin at the November 18, 2003, hearing	2874

XV

	Page
146. Statement for the Hearing Record of Reuven S. Avi-Yonah, Irwin I. Cohn Professor of Law and Director of the International Tax Master of Law Program at the University of Michigan Law School	2875
147. a.-b. Supplemental questions and answers for the record of KPMG. [Note: Exhibit 147a has been redacted, full document has been made a SEALED EXHIBIT.]	2878
148. Supplemental questions and answers for the record of Deutsche Bank	2939
149. Supplemental questions and answers for the record of HVB America, Inc.	2949
150. Supplemental questions and answers for the record of Quellos Group, LLC	2982
151. Supplemental questions and answers for the record of Sutherland Asbill & Brennan LLP [Note: Submission has been redacted, full document has been made a SEALED EXHIBIT.]	2984
152. Supplemental questions and answers for the record of Sidley Austin Brown & Wood	2999
153. Statement for the Record and supplemental questions and answers for the record of the Los Angeles Department of Fire & Police Pensions System	3016
154. Supplemental questions and answers for the record of the Internal Revenue Service	3025

Volume 4

155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals—Four KPMG Case Studies: FLIP, OPIS, BLIPS, and SC2</i> , a Report prepared by the Minority Staff of the Permanent Subcommittee on Investigations in conjunction with the Subcommittee hearings held November 18 and 20, 2003: [Note: Footnotes not listed are explanative, reference Subcommittee interviews for which records are not available to the public, or reference a widely available public document.]	
Footnote No. 1, SEALED EXHIBIT	*
Footnote No. 3, <i>See Hearing Exhibit No. 38 (above)</i>	528
Footnote No. 4, <i>See Hearing Exhibit No. 16 (above)</i>	453
Footnote No. 10, <i>See Attachments (2)</i>	3027, 3036
Footnote No. 11, <i>See Attachment</i>	3045
Footnote Nos. 15–16, <i>See Hearing Exhibit No. 106 (above)</i>	2622
Footnote No. 47, <i>See Hearing Exhibit No. 62 (above)</i>	614
Footnote No. 48, <i>See Attachment</i>	3047
Footnote No. 49, <i>See Hearing Exhibit No. 38 (above)</i>	528
Footnote No. 50, <i>See Attachment</i>	3053
Footnote No. 52, <i>See Attachment</i>	3054
Footnote No. 55, <i>See Footnote No. 52 (above)</i>	587
Footnote No. 56, SEALED EXHIBIT	*
Footnote No. 57, <i>See Attachment</i>	3244
Footnote Nos. 58–59, <i>See Footnote No. 57 (above)</i>	601
Footnote No. 65, <i>See Attachment</i>	3245
Footnote No. 66, <i>See Hearing Exhibit No. 14 (above)</i>	451
Footnote No. 68, <i>See Attachment</i>	3248
Footnote No. 69, <i>See Attachment</i>	3351
Footnote No. 70, <i>See Footnote 69 (above)</i>	644
Footnote No. 71, <i>See Hearing Exhibit No. 61 (above)</i>	612
Footnote No. 72, <i>See Footnote No. 52 (above)</i>	587

	Page
155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry</i> — Continued	
Footnote Nos. 73–74, <i>See Footnote No. 69 (above)</i>	644
Footnote Nos. 76–77, 79–81, <i>See Footnote No. 52 (above)</i>	587
Footnote No. 82, <i>See Footnote No. 69 (above)</i>	644
Footnote No. 83, <i>See Footnote No. 52 (above)</i>	587
Footnote No. 84, <i>See Attachment, Footnote No. 52 and Hearing Exhibit</i> <i>Nos. 96ff, 96hh, and 96kk (above)</i>	3375, 587, 1692
Footnote No. 87, <i>See Hearing Exhibit No. 73 (above)</i>	654
Footnote No. 88, <i>See Hearing Exhibit Nos. 73 and 85 (above)</i>	654, 669
Footnote No. 89, <i>See Hearing Exhibit No. 74 (above)</i>	655
Footnote No. 90, <i>See Hearing Exhibit No. 75 (above)</i>	656
Footnote Nos. 92–93, <i>See Hearing Exhibit No. 64 (above)</i>	621
Footnote No. 94, <i>See Hearing Exhibit Nos. 64, and 76–79</i> <i>(above)</i>	621, 660–663
Footnote Nos. 95–96, <i>See Hearing Exhibit No. 65 (above)</i>	623
Footnote No. 97, <i>See Hearing Exhibit No. 12 (above)</i>	448
Footnote No. 98, <i>See Attachment</i>	3468
Footnote No. 99, <i>See Attachment and Hearing Exhibit No. 65</i> <i>(above)</i>	3469, 623
Footnote No. 100, <i>See Hearing Exhibit No. 65 (above)</i>	623
Footnote No. 101, <i>See Hearing Exhibit No. 81 (above)</i>	665
Footnote No. 102, <i>See Hearing Exhibit No. 39 (above)</i>	532
Footnote No. 103, <i>See Attachment</i>	3472
Footnote No. 107, <i>See Attachment</i>	3474
Footnote Nos. 108–109, <i>See Hearing Exhibit No. 13 (above)</i>	450
Footnote No. 110, <i>See Hearing Exhibit No. 83 (above)</i>	667
Footnote No. 111, <i>See Hearing Exhibit Nos. 84 and 86 (above)</i>	668, 670
Footnote No. 113, <i>See Hearing Exhibit No. 41 (above)</i>	538
Footnote No. 115, <i>See Hearing Exhibit No. 38 (above)</i>	528
Footnote No. 116, <i>See Hearing Exhibit No. 2 (above)</i>	386
Footnote No. 117, <i>See Attachment</i>	3475
Footnote No. 121, <i>See Attachment</i>	3482
Footnote No. 122, <i>See Attachment</i>	3492
Footnote No. 123, <i>See Hearing Exhibit No. 87 (above)</i>	675
Footnote No. 124, <i>See Hearing Exhibit No. 49 (above)</i>	574
Footnote No. 125, <i>See Attachments (2) and Hearing Exhibit No. 49</i> <i>(above)</i>	3495, 574
Footnote No. 126, <i>See Attachments (3) and Hearing Exhibit No. 49</i> <i>(above)</i>	3506, 574
Footnote No. 127, <i>See Hearing Exhibit No. 59 (above)</i>	604
Footnote Nos. 128–129, <i>See Footnote No. 52 (above)</i>	587
Footnote No. 130, <i>See Attachment and Hearing Exhibit No. 54</i> <i>(above)</i>	3517, 595
Footnote No. 131, <i>See Hearing Exhibit No. 23 (above)</i>	488
Footnote No. 132, <i>See Attachment</i>	3519
Footnote No. 133, <i>See Hearing Exhibit No. 6 (above)</i>	412
Footnote No. 134, <i>See Hearing Exhibit No. 20 (above)</i>	463

XVII

	Page
155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry</i> —Continued	
Footnote No. 135, <i>See Attachment</i>	3520
Footnote No. 136, <i>See Hearing Exhibit No. 25 (above)</i>	492
Footnote No. 137, <i>See Hearing Exhibit No. 8 (above)</i>	423
Footnote No. 138, <i>See Attachment</i>	3522
Footnote No. 139, <i>See Hearing Exhibit No. 27 (above)</i>	495
Footnote No. 140, <i>See Hearing Exhibit No. 19 (above)</i>	460
Footnote No. 141, <i>See Attachment</i>	3523
Footnote Nos. 142–143, <i>See Hearing Exhibit No. 55 (above)</i>	597
Footnote No. 144, <i>See Attachment</i>	3530
Footnote Nos. 145–148, <i>See Footnote No. 144 (above)</i>	3530
Footnote No. 149, <i>See Attachment</i> (Partial document reprinted, full document SEALED EXHIBIT)	3557
Footnote No. 150, <i>See Attachment</i> (Partial document reprinted, full document SEALED EXHIBIT)	3568
Footnote No. 151, <i>See Attachment</i>	3572
Footnote No. 152, <i>See Attachment</i>	3573
Footnote No. 154, <i>See Attachments (2)</i>	3575
Footnote No. 155, <i>See Footnote No. 135 (above)</i>	2729
Footnote No. 156, <i>See Attachment</i>	3579
Footnote No. 157, <i>See Attachments (3), Footnote No. 156 and Hearing Exhibit No. 56 (above)</i>	3581, 3579, 599
Footnote No. 158, <i>See Hearing Exhibit No. 55 (above)</i>	597
Footnote No. 159, <i>See Hearing Exhibit No. 24 (above)</i>	490
Footnote No. 160, <i>See Attachments (2)</i>	3591
Footnote Nos. 161–162, <i>See Footnote No. 157 (above)</i>	3581
Footnote No. 163, <i>See Attachment</i>	3596
Footnote Nos. 166–167, <i>See Hearing Exhibit No. 21 (above)</i>	464
Footnote No. 168, <i>See Attachment, Footnote No. 156 and Hearing Exhibit Nos. 21 and 139m (above)</i>	3606, 3579, 464, 2746
Footnote Nos. 169 and 171, <i>See Hearing Exhibit No. 21 (above)</i>	464
Footnote No. 174, <i>See Footnote No. 152 (above)</i>	3573
Footnote No. 176, <i>See Hearing Exhibit No. 63 (above)</i>	617
Footnote No. 177, <i>See Hearing Exhibit No. 62 (above)</i>	614
Footnote No. 178, <i>See Hearing Exhibit No. 23 (above)</i>	488
Footnote No. 179, <i>See Attachment</i>	3607
Footnote No. 180, <i>See Footnote No. 57 (above)</i>	3244
Footnote No. 181, <i>See Footnote No. 151 (above)</i>	3572
Footnote No. 183, <i>See Attachment</i>	3620
Footnote Nos. 184–185, <i>See Footnote No. 57 (above)</i>	3244
Footnote No. 186, <i>See Attachment</i> (Partial document reprinted, full document SEALED EXHIBIT)	3621
Footnote Nos. 187–188, <i>See Footnote 186 (above)</i>	3621
Footnote No. 189, <i>See Footnote No. 56 (above)</i> SEALED EXHIBIT	*
Footnote Nos. 190–191, <i>See Hearing Exhibit No. 38 (above)</i>	528
Footnote No. 192, <i>See Attachment and Hearing Exhibit No. 38 (above)</i>	3623, 528

XVIII

	Page
155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry—Continued</i>	
Footnote Nos. 193–194, <i>See Hearing Exhibit No. 38 (above)</i>	528
Footnote No. 200, <i>See Hearing Exhibit No. 137 (above)</i>	2735
Footnote No. 201, <i>See Attachment</i> (Partial document reprinted, full document SEALED EXHIBIT)	3929
Footnote No. 203, <i>See Attachment and Hearing Exhibit No. 65</i>	3632, 623
Footnote No. 204, <i>See Hearing Exhibit No. 21 (above)</i>	464
Footnote No. 205, <i>See Hearing Exhibit No. 8 (above)</i>	423
Footnote No. 208, <i>See Hearing Exhibit No. 21 (above)</i>	464
Footnote No. 211, <i>See Hearing Exhibit Nos. 51 and 58 (above)</i>	585, 602
Footnote No. 213, <i>See Footnote No. 84 (above)</i>	3375
Footnote No. 214, <i>See Hearing Exhibit No. 110 (above)</i>	2657
Footnote No. 217, <i>See Footnote No. 84 (above)</i>	3375
Footnote No. 218, <i>See Hearing Exhibit No. 64 (above)</i>	621
Footnote No. 220, <i>See Hearing Exhibit No. 5 (above)</i>	408
Footnote No. 221, <i>See Hearing Exhibit No. 7 (above)</i>	415
Footnote No. 222, <i>See Hearing Exhibit Nos. 38 and 64 (above)</i>	528, 621
Footnote No. 223, <i>See Attachments (2) and Hearing Exhibit No. 15 (above)</i>	3635, 452
Footnote No. 227, <i>See Attachment</i>	3641
Footnote No. 228, <i>See Footnote No. 223</i>	3635
Footnote No. 230, <i>See Hearing Exhibit No. 105 (above)</i>	2619
Footnote No. 231, <i>See Footnote Nos. 157 and 163 (above)</i>	3581, 3596
Footnote No. 232, <i>See Attachment</i>	3643
Footnote No. 234, <i>See Hearing Exhibit No. 105 (above)</i>	2619
Footnote No. 235, <i>See Attachments (4)</i>	3644
Footnote No. 236, <i>See Hearing Exhibit No. 105 (above)</i>	2619
Footnote No. 238, <i>See Footnote No. 117</i>	3475
Footnote No. 239, <i>See Attachments (2) and Hearing Exhibit Nos. 111 and 129 (above)</i> ; two addition items for this footnote are SEALED EXHIBITS	3660, 2660, 2721
Footnote No. 240, <i>See Attachment and Hearing Exhibit No. 70 (above)</i>	3665, 646
Footnote No. 241, <i>See Footnote No. 235 and Hearing Exhibit No. 138 (above)</i>	3644, 2745
Footnote No. 242, <i>See Hearing Exhibit Nos. 103 and 104 (above)</i>	2615, 2618
Footnote No. 243, <i>See Hearing Exhibit No. 70 (above)</i>	646
Footnote No. 244, <i>See Attachment</i>	3668
Footnote Nos. 245–246, <i>See Hearing Exhibit No. 113 (above)</i>	2679
Footnote Nos. 248–250, <i>See Hearing Exhibit No. 110 (above)</i>	2657
Footnote No. 251, <i>See Footnote No. 84</i>	3375
Footnote No. 252, <i>See Hearing Exhibit No. 105 (above)</i>	2619
Footnote Nos. 253–255, <i>See Hearing Exhibit No. 106 (above)</i>	2622
Footnote No. 256, <i>See Attachment</i>	3670
Footnote No. 257, <i>See Attachment and Hearing Exhibit No. 106 (above)</i>	3671, 2622

XIX

	Page
155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry</i> —	
Continued	
Footnote No. 258, <i>See Hearing Exhibit No. 106 (above)</i>	2622
Footnote No. 261, <i>See Footnote No. 201 (above)</i>	3929
Footnote No. 262, <i>See Attachment</i>	3672
Footnote No. 263, <i>See Attachment</i>	3678
Footnote No. 265, <i>See Attachment, Footnote No. 244 and Hearing Exhibit Nos. 70 and 108 (above)</i>	3679, 3668, 646, 2647
Footnote No. 266, <i>See Attachments (2)</i> (One document partially reprinted, full document is (SEALED EXHIBIT))	3681
Footnote No. 267, <i>See Footnote No. 266 (above)</i>	3681
Footnote No. 268, <i>See Attachment</i>	3687
Footnote No. 270, <i>See Footnote No. 154 (above)</i>	3575
Footnote No. 271, <i>See Footnote No. 237 (above)</i> (Found in the files of the Subcommittee)	*
Footnote No. 272, <i>See Attachment</i>	3690
Footnote No. 273, <i>See Footnote No. 272 (above)</i>	3690
Footnote No. 274, <i>See Attachment</i>	3697
Footnote No. 275, <i>See Attachments (5)</i>	3703
Footnote No. 276, <i>See Footnote No. 275 (above)</i>	3703
Footnote No. 278, <i>See Hearing Exhibit No. 101 (above)</i>	2607
Footnote No. 279, <i>See Attachment</i>	3711
Footnote No. 280, <i>See Attachment</i>	3712
Footnote No. 281, <i>See Footnote No. 117 and Hearing Exhibit No. 112 (above)</i>	3475, 2678
Footnote No. 282, <i>See Hearing Exhibit Nos. 64, 69 and 81 (above)</i>	621, 644, 665
Footnote No. 283, <i>See Hearing Exhibit No. 81 (above)</i>	665
Footnote No. 284, <i>See Attachment</i>	3714
Footnote No. 285, <i>See Attachment</i>	3717
Footnote No. 286, <i>See Attachment</i> (Four additional items for this footnote are SEALED EXHIBITS)	3718
Footnote No. 293, <i>See Hearing Exhibit No. 120 (above)</i>	2699
Footnote No. 294, <i>See Hearing Exhibit No. 119 (above)</i>	2696
Footnote No. 295, <i>See Attachment</i>	3719
Footnote No. 296, <i>See Footnote No. 117 and Hearing Exhibit Nos. 42 and 112 (above)</i>	3475, 543, 2678
Footnote No. 299, <i>See Footnote No. 156 (above)</i>	3579
Footnote No. 301, <i>See Attachment</i>	3722
Footnote No. 302, <i>See Attachment</i>	3754
Footnote No. 303, <i>See Hearing Exhibit No. 21 (above)</i>	464
Footnote No. 306, <i>See Attachment</i>	3756
Footnote No. 307, <i>See Attachment</i>	3757
Footnote No. 308, <i>See Footnote No. 307 (above)</i>	3757
Footnote No. 310, <i>See Hearing Exhibit No. 128 (above)</i>	2720
Footnote No. 312, <i>See Footnote No. 52 (above)</i>	3054
Footnote No. 313, <i>See Attachments (3)</i>	3767
Footnote No. 314, <i>See Hearing Exhibit No. 38 (above)</i>	528

	Page
155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry</i> — Continued	
Footnote No. 319, <i>See Attachments (2)</i>	3775
Footnote No. 320, <i>See Attachment</i>	3779
Footnote No. 321, <i>See Attachments (2)</i>	3795
Footnote Nos. 322–323, <i>See Footnote No. 320 (above)</i>	3779
Footnote No. 324, <i>See Attachment and Footnote No. 320</i>	3801, 3779
Footnote No. 327, <i>See Attachment</i>	3812
Footnote No. 328, <i>See Attachment</i>	3813
Footnote No. 329, <i>See Attachments (2)</i>	3814
Footnote No. 330, <i>See Footnote No. 329 (above)</i>	3814
Footnote No. 331, <i>See Attachments (3)</i>	3816
Footnote No. 332, <i>See Attachments (3)</i>	3822
Footnote No. 333, <i>See Hearing Exhibit No. 21 (above)</i>	464
Footnote Nos. 335–336, <i>See Hearing Exhibit No. 43 (above)</i>	545
Footnote No. 337, <i>See Hearing Exhibit No. 128 (above)</i>	2720
Footnote No. 338, <i>See Hearing Exhibit No. 103 (above)</i>	2615
Footnote No. 339, <i>See Hearing Exhibit No. 104 (above)</i>	2618
Footnote No. 340, <i>See Footnote No. 154 (above)</i>	3575
Footnote No. 341, <i>See Attachment</i>	3830
Footnote No. 342, <i>See Attachments (2)</i>	3831
Footnote No. 343, <i>See Footnote No. 203 (above)</i>	3632
Footnote Nos. 344 and 346, <i>See Hearing Exhibit No. 28 (above)</i>	496
Footnote No. 347, <i>See Footnote No. 122 (above)</i>	3492
Footnote No. 348, <i>See Hearing Exhibit No. 28 (above)</i>	496
Footnote Nos. 349–350, <i>See Footnote No. 163 (above)</i>	3596
Footnote No. 351, <i>See Footnote No. 117 (above)</i>	3475
Footnote No. 352, <i>See Footnote No. 52 (above)</i>	3054
Footnote No. 355, <i>See Attachment</i>	3835
Footnote No. 356, <i>See Footnote No. 355 (above)</i>	3835
Footnote No. 359, <i>See Attachment and Footnote No. 203 (above)</i>	3840
Footnote No. 360, <i>See Hearing Exhibit No. 121 (above)</i>	3482
Footnote No. 361, <i>See Attachment and Hearing Exhibit No. 58 (above)</i>	3842, 602
Footnote No. 362, <i>See Footnote No. 361 (above)</i>	3842
Footnote No. 363, <i>See Attachment</i>	3847
Footnote No. 364, <i>See Attachment</i>	3848
Footnote No. 367, <i>See Footnote No. 154 (above)</i>	3575
Footnote Nos. 368–369, <i>See Footnote No. 52 (above)</i>	3054
Footnote No. 370, <i>See Hearing Exhibit No. 115 (above)</i>	2686
Footnote No. 371, <i>See Footnote No. 52 (above)</i>	3054
Footnote No. 372, <i>See Hearing Exhibit No. 114 (above)</i>	2681
Footnote No. 373, <i>See Attachments (2) and Footnote Nos. 154 and 203 (above)</i>	3850, 3575, 3632
Footnote No. 374, <i>See Footnote No. 373 (above)</i>	3850
Footnote No. 375, <i>See Footnote No. 144 (above)</i>	3530
Footnote No. 376, <i>See Footnote No. 150 (above)</i>	3568
Footnote No. 377, <i>See Footnote No. 151 (above)</i>	3572
Footnote No. 378, <i>See Footnote No. 355 (above)</i>	3835
Footnote Nos. 379–382, <i>See Hearing Exhibit No. 115 (above)</i>	2686

155. Documents relating to Footnotes found in <i>U.S. Tax Shelter Industry</i> —	Page
Continued	
Footnote No. 383, <i>See Attachment and Hearing Exhibit No. 46 (above)</i>	3853, 560
Footnote No. 384, <i>See Hearing Exhibit No. 44 (above)</i>	555
Footnote No. 385, <i>See Attachment</i>	3854
Footnote No. 386, <i>See Hearing Exhibit No. 38 (above)</i>	528

Unknown

From: DeLap, Larry [ldelap@KPMG.COM]
 Sent: Friday, March 24, 2000 12:50 PM
 To: Springer, Mark A; Galbreath, Phillip L
 Cc: Manth, Larry E; Smith, Richard H (WNT)
 Subject: RE: S-corp Product

I'm okay with either.

> -----Original Message-----
 > From: Springer, Mark A
 > Sent: Friday, March 24, 2000 5:26 AM
 > To: Galbreath, Phillip L; DeLap, Larry
 > Cc: Manth, Larry E; Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> I think the last thing we or a client would want is a letter in the
 > files regarding a tax planning strategy for which the acronym when
 > pronounced sounds like we are saying "escapes"...suggest we change the
 > reference either to "S Corporation Strategy", or the new SC2 name (but
 > I prefer the former).

> Larry D??

> Mark Springer
 > KPMG Tax Innovation Center
 > 202-533-3076
 > maspringer@kpmg.com

> -----Original Message-----
 > From: Galbreath, Phillip L
 > Sent: Thursday, March 23, 2000 6:12 PM
 > To: DeLap, Larry
 > Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> Attached is the S-CAEPS engagemet letter which has been revised to
 > incorporate your comments. Nancy Galib (member of the WNT TCS group)
 > reviewed and provided comments which have been incorporated as well.
 > Please review and provide me with any additional comments you have.
 > Thanks.

> << File: S-CAEPS_ENGAGE.DOC >>

> Phillip Galbreath
 > KPMG Tax Innovation Center
 > Phone: 202.533.4162
 > Fax: 202.533.4163
 > MailTo:pgalbre@kpmg.com

> -----Original Message-----
 > From: DeLap, Larry
 > Sent: Tuesday, March 21, 2000 7:57 PM
 > To: Galbreath, Phillip L
 > Cc: Springer, Mark A; Manth, Larry E
 > Subject: FW: S-corp Product

> Phillip -

> I think that the engagement letter needs to explicitly state that

> the client needs to engage legal counsel to advise on non-tax legal
> aspects of the transaction and to draft required legal documents.
>
> I suggest you have the WNT TCS group look at the letter to see if
> they have any suggestions to add a greater business purpose/economic
> substance concern.
>
> My principal concern lies with how we introduce the donee to the
> client, whether we may have an "alliance" relationship with the donee
> (particularly if a particular donee participates in multiple
> transactions), and whether we should have some sort of written
> agreement with the donee if deemed not to be an alliance. Larry Manth
> can discuss those particular issues with me, but it seems to me the
> Scope of Services should say something about how we help the client
> select the donee.
>
> In the absence of an ICV, how do we establish the fixed fee?
>
> Presumably, a valuation will be needed to establish the amount of
> the charitable contribution. Shouldn't engagement letter say something
> about need for a valuation?
>
> The "restriction on use" language needs to be changed from "will not
> be provided" to "may not be relied upon".
>
> Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 20, 2000 4:28 PM
> To: DeLap, Larry
> Subject: FW: S-corp Product
>
> Please see messages below. I know you are already aware of this
> strategy and may have already reviewed some of the related materials.
> I received and responded to questions raised by Chris Galer
> (DPP-Assurance) last week. Based on the messages below, Larry Manth
> will be sending the whitepaper and powerpoint presentation directly to
> you. Attached below is the sample engagement letter. Please review
> and provide me with your comments. At this point, there will be no
> Tax Solution Alert or other toolkit documents.
>
> << File: S-CAEPS_ENGAGE.DOC >>
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 5:08 PM
> To: Springer, Mark A; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard M (WNT); Atkin,
> Andrew S; Duncan, Douglas F; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
> Mark and Phillip, I believe that we have sent the engagement letter
> to Larry DeLap. Also, we do not plan on using an ICV letter. I
> believe the only missing item is the powerpoint presentation. We are
> just about complete (I still have not heard from the Southeast
> regarding a product champion). We are working on an updated technical
> write-up covering the assignment of income issues, changing the put

3029

> arrangement (Richard Bailine), and deleting 501(c)(3)'s. Please let
> me know if we are missing anything. Thanks, Larry

>
> -----Original Message-----
> From: Springer, Mark A
> Sent: Monday, March 20, 2000 1:37 PM
> To: Manth, Larry E; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product

>
> I believe this leaves as the only open item the
> assignment of income issues.

> Larry: Assume you are working directly w/ Mark
> Watson.

> Philip: Are the other toolkit items (eng letter,
> ICV letter) ready to go to Larry Delap w/ formal request for review
> and approval to deploy the solution?

>
> Mark Springer
> KPMG Tax Innovation Center
> 202-533-3076
> maspringer@kpmg.com

>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 3:42 PM
> To: Bailine, Richard W; Kelliher, William B
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
> Subject: RE: S-corp Product

>
> Richard, we will send you a draft of a pledge for
> your review, thanks, Larry

>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 12:40 PM
> To: Bailine, Richard W; Kelliher, William B;
> Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A
> Subject: RE: S-corp Product

>
> Folks--One point I should have made clear. While I
> have no problem with the timing of the shareholders funding of the
> pledge being stretched out, one thing that can NOT happen is that the
> funding can NOT be tied to, or contingent upon, the receipt of
> distributions (or the existence of profits etc) from the S Corp. To do
> so would simply resurrect all the issues we just eliminated. Thanks.

>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 3:34 PM
> To: Kelliher, William B; Manth, Larry E
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product

>
> Larry--Bill Kelliher and I had lunch today and
> discussed this business solution idea. We are in agreement that having
> the Put to the S Corp at FMV as of the date of exercise of the Put
> with a shareholder pledge to Exempt-Org as suggested in my March 16th
> email below will enhance the technical aspects of this solution.

>
> I would think that the economics of having the

3

Proprietary Material
Confidentiality Requested

KPMG 0016517

> shareholder make this pledge would not be materially different (in
> most
> cases) than having the S Corp do so. One would think the major wealth
> component of most S Corp shareholders is their S Corp stock and,
> ultimately the source of the funds to make this pledge (if funding should
> ever be necessary) would be from the S Corp. I have no problem with the
> shareholders pledge stretching over more than one year to facilitate a
> smooth cash flow. Thus, one will not know for two years (i.e. the expected
> timing of the exercise of the Put) whether funding the pledge will be
> necessary. Assume such funding is necessary, I have no problem with the
> shareholders pledge saying "I will fund this amount over 2 years (or 3, or
> 4 etc years)". This cash flow timing should be worked out between the
> Exempt-Org and the shareholder and be mutually agreeable to them. All I am
> interested in is that this "pledge/guaranty" does not come from the S Corp
> so that in its capacity as an S Corp shareholder, Exempt-Org has no
> downside protection vis-a-vis the stock ownership and no right to a
> preferential distribution. Rights, if any, come from an individual, not
> the corporation.

>
> With these changes, I approve the Sub Chapter C
> aspects of this business solution. Thanks to all for your valuable
> input and help to achieve the overall desired result!

> -----Original Message-----

> From: Kelliher, William B
> Sent: Monday, March 20, 2000 2:53 PM
> To: Manth, Larry E; Bailine, Richard W
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product

> It's correct (reg. sec. 1.1368-2(d)(1)(i)).

> Bill

> -----Original Message-----

> From: Manth, Larry E
> Sent: Monday, March 20, 2000 9:35 AM
> To: Bailine, Richard W; Kelliher, William B
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product

> Richard, I like your suggestion on the put. If you
> think it strengthens our case, all the better! From the S-corp side,
> since most shareholders think the company is going up in value, they
> should not care. The practical concern is if the company decreases in
> value and the shareholder has to pay cash to the tax-exempt -- will
> the shareholder have enough cash to make the payment if they had not
> been paid distributions for two years? Perhaps we could extend the
> pledge for a year longer than the put.

> With respect to the AAA reduction, Bill can confirm
> this, the example on page 8 is correct.

> Also, with respect to UBIT issues, the tax-exempts
> we are dealing with are using section 115 to exclude the income from
> UBIT, so they are not concerned about UBIT.

> Thanks, Larry

> -----Original Message-----

> From: Bailine, Richard W
> Sent: Thursday, March 16, 2000 4:06 PM
> To: Manth, Larry E; Kelliher, William B
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product

>
> Larry/Bill--I think we need to talk in re the
> following issues.
>
> Pg 8 of the opinion states that S Corp will reduce
> AAA by 90% (or some \$7.2 million) even though the amount paid out in
> redemption of stock is a mere \$1.3 million. Is this correct?
>
> More importantly, I continue to be concerned that a guaranteed PUT
> right has the potential effect of giving IRS an argument that no stock
> has been given to Exempt-Org as Exempt-Org has no downside. More over,
> as this right to get a guaranteed FMV price runs from the S Corp to
> Exempt-Org, even if exempt-Org is deemed to be a shareholder why don't
> we have a second class of stock issue as Exempt-Org certainly has
> distribution rights that differ from, and are superior to, those of
> the other shareholder.
>
> Can we solve all this as follows;
>
> (i) Assume the S Corp stock has a value of \$1.3
> million on the date of the gift to Exempt-Org.
>
> (ii) Give Exempt-Org a right to Put the stock back
> to S Corp at FMV as of the date the Put is exercised.
>
> (iii) Have Shareholder make a pledge to Exempt-Org
> such that he will contribute an amount of money equal to the amount,
> if any, that any Put proceeds received by Exempt-Org are less than
> \$1.3 million.
>
> In this way, Exempt-Org is assured of getting the
> cash BUT the assurance does not come from S Corp. Shouldn't this
> eliminate the above concerns. Doesn't it also have the effect of
> helping Exempt-Org; to wit, if the Put is exercised at \$1 million then
> Shareholder must give \$300,000 to Exempt-Org. Isn't this \$300,000
> clearly a charitable gift so that Exempt-Org has no UBIT issues
> whereas the redemption proceeds may be UBIT.
>
> Thoughts. Let's talk on Friday.
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, March 15, 2000 12:53 PM
> To: Bailine, Richard W
> Cc: Smith, Richard H (WNT); Galbreath, Phillip
> L; Springer, Mark A; Peters, Marsha F; Atkin, Andrew S; Duncan,
> Douglas F; Huber, Robert
> Subject: S-corp Product
>
> Rick, please see my comments below.
>
> Thanks, Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 4:49 PM
> To: Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Peters, Marsha F
> Subject: FW: S-CAEPS
>
> Below are Rick Bailine's comments relating to the
> Sub C issues in the S-CAEPS whitepaper.
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162

3032

> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 13, 2000 7:29 PM
> To: Galbreath, Phillip L
> Cc: Bloom, Gilbert D; Springer, Mark A; Peters,
> Marsha F
> Subject: RE: S-CAEPS
>
> Phillip--I have read the attached and have the
> following comments related solely to Sub Chapter C.
>
> 1. This appears to be little more than a old give
> stock to charity and then redeem it play and as pointed out in the
> write-up at footnote 51, the IRS has, for the most part, thrown in the
> towel on these (despite a strong record in court). Having said this
> please read on.
>
> [Manth, Larry E] Yes, very similar, but during the
> time the tax-exempt owns the stock it will be allocated 90% of the
> income, be paid no distributions, and be redeemed for a small value.
>
> 2. I think the section 269 discussion is weak. It
> seems clear to me there is an acquisition of control by Exempt-Org as
> it acquires 90% of the number of shares of the S Corp and even if
> discounted at 35% (which would be questionable I think) for lack of
> voting rights as discussed in the write-up at footnote 4, this 90% of
> the number of shares should have >50% of the value of the S Corp (90%
> times 65%=58.5%). Thus, I think the argument is that (i) Exempt-Org
> receives no tax benefit from the acquisition of control, its tax
> benefits stem from its status under section 501 and (ii) the S Corp
> gets no tax benefit from the acquisition of control as its tax
> benefits stem from its status under section 1361 et seq. Thus, the
> acquisition of control is not material to any tax benefit. The
> write-up does go down this path but spends more time arguing that
> there is no acquisition of control which I think is a mistake. Also,
> the write-up speaks in very conclusive terms when it should be using
> words like "should not apply" as opposed to "...section 269 does not
> apply...". See page 7.
>
> [Manth, Larry E] See revised technical paper
> attached. Please note that the way the transaction is structured, the
> non-voting stock will not be greater than 50% of the value of the
> S-corp (the warrants significantly dilute the value).
>
> 3. My biggest concern is the redemption right given
> to Exempt-Org; why does this right guaranty Exempt-Org will receive
> cash equal to the greater of FMV at time of redemption versus FMV at
> date of gift? This right takes all downside risk away from Exempt-Org
> and one of the hallmarks of ownership is that the owner inherits the
> "benefits and burdens" of ownership. By relieving Exempt-Org of the
> burden of downside risk are we not allowing IRS an alternative
> argument that Shareholder did NOT give S Corp stock to Exempt-Org,
> rather what was truly given was a right to a fixed amount of cash plus
> a SAR (Stock Appreciation Right).
>
> At page 11, the write-up discusses the potential
> issue that the warrants may be stock and in this light looks at Rev
> Rul 82-150. As for the analysis on this point, I think the write-up is
> fine but this revenue ruling also clearly tells us that if one is to
> be viewed as the owner of equity, one must assume the risks associated
> with equity ownership. Traditionally, one such risk is the risk the
> equity investment will decrease in value. Exempt-Org has no such risk

6

Proprietary Material
Confidentiality Requested

KPMG 0016520

> and, therefore, arguably may not be viewed as an equity owner.

> Moreover, why is this downside protection either
> necessary or desirable? I would think giving Exempt-Org a right to
> demand redemption (i.e. a "put") at FMV as of the date of exercise of
> the put, is more in keeping with the desires of Shareholder and
> Exempt-Org gets a windfall even if it get one cent! It would also seem
> that put at FMV as of date of exercise is truly in keeping with the
> requirements of Treas Reg 1.1361-1(l)(2)(iii). See footnote 20, page
> 6.

> [Manth, Larry E] The reason we guarantee the
> tax-exempt a minimum is that there is a potential burden -- federal
> taxes. It is not a certainty that the tax-exempt is totally exempt
> from tax on holding the stock. Also, very few tax-exempts would ever
> take this stock because of the UBIT concerns. So we are using the
> floor as an incentive for the tax-exempts to take the stock.
> Hopefully the discussion under economic substance regarding beneficial
> ownership on pages 12 through 19 will suffice in addressing your
> concerns on ownership issues.

> << File: S_Corp_Strategy.doc >>

> Let's chat.

> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 2:46 PM
> To: Bailine, Richard W
> Subject: FW: S-CAEPS

> Attached below is the most recent version of the
> S-CAEPS whitepaper. As I was telling you, this Tax Solution is
> getting some very high level (Stein/Rosenthal) attention. Please
> review the whitepaper as soon as possible and provide your comments to
> Larry Manth directly. Please copy Richard Smith, Mark Springer, Marsha Peters, and me
> on your message to Larry. Thanks for your help.

> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com

> -----Original Message-----
> From: Manth, Larry E
> Sent: Sunday, March 12, 2000 10:35 AM
> To: Watson, Mark T; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; Delap, Larry; Galbreath, Phillip L
> Cc: Atkin, Andrew S; Duncan, Douglas P; Huber,
> Robert
> Subject: RE: S-CAEPS

> Mark, thanks for your comments. I will address each
> one separately.

> 1) Assignment of Income Issues. We have included
> an additional paragraph under the assignment of income section. But
> also see the economic substance arguments. Bill Kelliher

> substantially enhanced that section and it addresses many issues,
> including beneficial ownership and income allocation.
>
> 2) No charitable or gift tax deduction and
> reallocation of income back to original shareholders. Again, I think
> the economic substance arguments cover these issues. But I am not
> convinced that the Service would be successful in disallowing a
> charitable deduction. After the transaction, the tax-exempt will have
> cash based on the fair market value of the stock. It does nothing but
> hold the stock. The split-dollar transactions have the tax-exempt buy
> insurance. Also, this transaction is quite similar to the charitable
> FLP. Is this a concern for that transaction as well?
>
> 3) Per Larry DeLap's E-mail, we are not discussing penalty issues.
>
> 4) Self-Dealing Issues. We have inserted a
> discussion on section 4958, drafted by our EXO-Tax group in D.C. We do,
> however, plan on using only 401's.

Larry

<< File: S_Corp_Strategy.doc >>

-----Original Message-----

From: Watson, Mark T
Sent: Friday, March 10, 2000 8:24 AM
To: Manth, Larry E; Smith, Richard H (WNT);
Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
Subject: S-CAEPS

> OK. I have reviewed the revised S-CAEPS white paper
> and I am still not convinced that the assignment of income issues
> associated with this strategy and the ramifications of Notice 99-36
> have been adequately addressed and/or considered. The assignment of
> income discussion in the white paper is very brief and contains little
> case law analysis. While the conclusion reached in the white paper on
> this matter may very well be correct, the brief discussion contained
> in the white paper does not give me a tremendous amount of comfort
> that all of the relevant cases and rulings have been considered,
> particularly wrt whether or not the Shareholder is assigning the S
> corp's earnings to the Exempt Organization.

> More importantly, the paper's discussion of Notice
> 99-36 seems to miss the point. Yes, we can certainly distinguish the
> S-CAEPS transaction from the transaction that was the subject of
> Notice 99-36, but my point in raising Notice 99-36 is to make sure
> everyone is aware of the potential downside of this transaction. If
> the Service comes after the S-CAEPS transaction the way it attacked
> the Charitable Split-Dollar transaction (and I believe Notice 99-36
> and the recent section 643(a)(7) regulations indicate it will),
> clients who enter into the S-CAEPS transaction could be faced with a
> situation where: (1) they don't get an income OR gift tax charitable
> contribution deduction for the contribution of the S-Corp stock to
> charity (and, thus, they may incur a substantial gift tax liability);
> and (2) they are required to recognized all or most of the S corp's
> earnings. Further, as stated in Notice 99-36, the Service may attempt
> to impose a variety of penalties on the participants in this
> transaction (including KPMG) including the penalty under section 6701
> for aiding and abetting the understatement of tax liability. Finally,
> the white paper contains no discussion as to why the Service cannot
> claim the S-CAEPS transaction involves private inurement, an
> impermissible private benefit, or self dealing, all issues raised in
> Notice 99-36. Perhaps if the "Exempt-Org" is a section 401(a) entity rather than a
> section 501(c)(3) entity these issues go away. If so, the

3035

```
> white paper should so indicate.  
>  
> Mark T. Watson  
> Partner  
> KPMG - Washington National Tax  
> 202-533-3092 (phone)  
> 202-533-8451 (fax)  
>
```

Unknown

From: DeLap, Larry [ldelap@KPMG.COM]
 Sent: Friday, March 24, 2000 12:47 PM
 To: Springer, Mark A; Galbreath, Phillip L
 Cc: Manth, Larry E; Smith, Richard H (WNT)
 Subject: RE: S-corp Product

Mark -

You make a good point. The SC squared that Larry Manth came up with seems okay, although, as Richard suggests, it could be even better to get the charitable intent directly in the name.

Larry

> -----Original Message-----
 > From: Springer, Mark A
 > Sent: Friday, March 24, 2000 7:49 AM
 > To: DeLap, Larry; Galbreath, Phillip L
 > Cc: Manth, Larry E; Smith, Richard H (WNT)
 > Subject: RE: S-corp Product
 >
 >
 > Larry:
 >
 > Did you see my earlier message re name...I really don't think we
 > should refer to this as S-CAEPS ANYPLACE. If you agree, I will have
 > Phillip replace all S-S-CAEPS references with something much more
 > benign.
 >
 > Mark Springer
 > KPMG Tax Innovation Center
 > 202-533-3076
 > maspringer@kpmg.com

> -----Original Message-----
 > From: DeLap, Larry
 > Sent: Friday, March 24, 2000 10:12 AM
 > To: Galbreath, Phillip L
 > Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> << File: S-CAEPS_ENGAGE.DOC >>

> See additional revisions attached.

> -----Original Message-----
 > From: Galbreath, Phillip L
 > Sent: Thursday, March 23, 2000 3:12 PM
 > To: DeLap, Larry
 > Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H
 > (WNT)
 > Subject: RE: S-corp Product

> Attached is the S-CAEPS enagement letter which has been revised to
 > incorporate your comments. Nancy Galib (member of the WNT TCS
 > group) reviewed and provided comments which have been incorporated as
 > well. Please review and provide me with any additional comments you
 > have. Thanks.

> << File: S-CAEPS_ENGAGE.DOC >>

> Phillip Galbreath

1

KPMG 0016524

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 10

3037

> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>

> -----Original Message-----

> From: DeLap, Larry
> Sent: Tuesday, March 21, 2000 7:57 PM
> To: Galbreath, Phillip L
> Cc: Springer, Mark A; Manth, Larry E
> Subject: FW: S-corp Product

> Phillip -

> I think that the engagement letter needs to
> explicitly state that the client needs to engage legal counsel to
> advise on non-tax legal aspects of the transaction and to draft
> required legal documents.

> I suggest you have the WNT TCS group look at the
> letter to see if they have any suggestions to add a greater business
> purpose/economic substance concern.

> My principal concern lies with how we introduce the
> donee to the client, whether we may have an "alliance" relationship
> with the donee (particularly if a particular donee participates in
> multiple transactions), and whether we should have some sort of
> written agreement with the donee if deemed not to be an alliance.
> Larry Manth can discuss those particular issues with me, but it seems
> to me the Scope of Services should say something about how we help the
> client select the donee.

> In the absence of an ICV, how do we establish the
> fixed fee?

> Presumably, a valuation will be needed to establish
> the amount of the charitable contribution. Shouldn't engagement letter
> say something about need for a valuation?

> The "restriction on use" language needs to be
> changed from "will not be provided" to "may not be relied upon".

> Larry

> -----Original Message-----

> From: Galbreath, Phillip L
> Sent: Monday, March 20, 2000 4:28 PM
> To: DeLap, Larry
> Subject: FW: S-corp Product

> Please see messages below. I know you are already
> aware of this strategy and may have already reviewed some of the
> related materials. I received and responded to questions raised by
> Chris Galer
> (DPP-Assurance) last week. Based on the messages below, Larry Manth will
> be sending the whitepaper and powerpoint presentation directly to you.
> Attached below is the sample engagement letter. Please review and provide
> me with your comments. At this point, there will be no Tax Solution Alert
> or other toolkit documents.

> << File: S-CAEPS_ENGAGE.DOC >>

> Phillip Galbreath
> KPMG Tax Innovation Center

KPMG 0016525

3038

> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbre@kpmg.com
>
>
>
>
>
>

> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 5:08 PM
> To: Springer, Mark A; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
>

> Mark and Phillip, I believe that we have sent the engagement letter
> to Larry DeLap. Also, we do not plan on using an ICV letter. I
> believe the only missing item is the powerpoint presentation. We are
> just about complete (I still have not heard from the Southeast
> regarding a product champion). We are working on an updated technical
> write-up covering the assignment of income issues, changing the put
> arrangement (Richard Bailine), and deleting 501(c)(3)'s. Please let
> me know if we are missing anything. Thanks, Larry
>
>

> -----Original Message-----
> From: Springer, Mark A
> Sent: Monday, March 20, 2000 1:37 PM
> To: Manth, Larry E; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
>

> I believe this leaves as the only open item the
> assignment of income issues.
>
>

> Larry: Assume you are working directly w/ Mark
> Watson.
>
>

> Philip: Are the other toolkit items (eng letter,
> ICV letter) ready to go to Larry DeLap w/ formal request for review
> and approval to deploy the solution?
>
>

> Mark Springer
> KPMG Tax Innovation Center
> 202-533-3076
> maspringer@kpmg.com
>
>

> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 3:42 PM
> To: Bailine, Richard W; Kelliher, William B
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
> Subject: RE: S-corp Product
>
>

> Richard, we will send you a draft of a pledge for
> your review, thanks, Larry
>
>

> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 12:40 PM
> To: Bailine, Richard W; Kelliher, William B;
> Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A
> Subject: RE: S-corp Product
>
>

> Folks--One point I should have made clear. While I

> have no problem with the timing of the shareholders funding of the
 > pledge being stretched out, one thing that can NOT happen is that the
 > funding can NOT be tied to, or contingent upon, the receipt of
 > distributions (or the existence of profits etc) from the S Corp. To do
 > so would simply resurrect all the issues we just eliminated. Thanks.

>
 > -----Original Message-----
 > From: Bailine, Richard W
 > Sent: Monday, March 20, 2000 3:34 PM
 > To: Kelliher, William B; Manth, Larry E
 > Cc: Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> Larry--Bill Kelliher and I had lunch today and
 > discussed this business solution idea. We are in agreement that having
 > the Put to the S Corp at FMV as of the date of exercise of the Put
 > with a shareholder pledge to Exempt-Org as suggested in my March 16th
 > email below will enhance the technical aspects of this solution.

> I would think that the economics of having the
 > shareholder make this pledge would not be materially different (in
 > most
 > cases) than having the S Corp do so. One would think the major wealth
 > component of most S Corp shareholders is their S Corp stock and,
 > ultimately the source of the funds to make this pledge (if funding should
 > ever be necessary) would be from the S Corp. I have no problem with the
 > shareholders pledge stretching over more than one year to facilitate a
 > smooth cash flow. Thus, one will not know for two years (i.e. the expected
 > timing of the exercise of the Put) whether funding the pledge will be
 > necessary. Assume such funding is necessary, I have no problem with the
 > shareholders pledge saying "I will fund this amount over 2 years (or 3, or
 > 4 etc years)". This cash flow timing should be worked out between the
 > Exempt-Org and the shareholder and be mutually agreeable to them. All I am
 > interested in is that this "pledge/guaranty" does not come from the S Corp
 > so that in its capacity as an S Corp shareholder, Exempt-Org has no
 > downside protection vis-a-vis the stock ownership and no right to a
 > preferential distribution. Rights, if any, come from an individual, not
 > the corporation.

> With these changes, I approve the Sub Chapter C
 > aspects of this business solution. Thanks to all for your valuable
 > input and helping to achieve the overall desired result!

>
 > -----Original Message-----
 > From: Kelliher, William B
 > Sent: Monday, March 20, 2000 2:53 PM
 > To: Manth, Larry E; Bailine, Richard W
 > Cc: Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> It's correct (reg. sec. 1.1368-2(d)(1)(i)).

> Bill

>
 > -----Original Message-----
 > From: Manth, Larry E
 > Sent: Monday, March 20, 2000 9:35 AM
 > To: Bailine, Richard W; Kelliher, William B
 > Cc: Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> Richard, I like your suggestion on the put. If you
 > think it strengthens our case, all the better! From the S-corp side,
 > since most shareholders think the company is going up in value, they
 > should not care. The practical concern is if the company decreases in
 > value and the shareholder has to pay cash to the tax-exempt -- will
 > the shareholder have enough cash to make the payment if they had not

> been paid distributions for two years? Perhaps we could extend the
> pledge for a year longer than the put.

>

> With respect to the AAA reduction, Bill can confirm
> this, the example on page 8 is correct.

>

> Also, with respect to UBIT issues, the tax-exempts
> we are dealing with are using section 115 to exclude the income from
> UBIT, so they are not concerned about UBIT.

>

Thanks, Larry

>

>

>

>

>

-----Original Message-----

From: Bailine, Richard W

Sent: Thursday, March 16, 2000 4:06 PM

To: Manth, Larry E; Kelliher, William B

Cc: Smith, Richard H (WNT)

Subject: RE: S-corp Product

>

> Larry/Bill--I think we need to talk in re the
> following issues.

>

> Pg 8 of the opinion states that S Corp will reduce
> AAA by 90% (or some \$7.2 million) even though the amount paid out in
> redemption of stock is a mere \$1.3 million. Is this correct?

>

> More importantly, I continue to be concerned that a guaranteed PUT.
> right has the potential effect of giving IRS an argument that no stock
> has been given to Exempt-Org as Exempt-Org has no downside. More over,
> as this right to get a guaranteed FMV price runs from the S Corp to
> Exempt-Org, even if exempt-Org is deemed to be a shareholder why don't
> we have a second class of stock issue as Exempt-Org certainly has
> distribution rights that differ from, and are superior to, those of
> the other shareholder.

>

Can we solve all this as follows;

>

> (i) Assume the S Corp stock has a value of \$1.3
> million on the date of the gift to Exempt-Org.

>

> (ii) Give Exempt-Org a right to Put the stock back
> to S Corp at FMV as of the date the Put is exercised.

>

> (iii) Have Shareholder make a pledge to Exempt-Org
> such that he will contribute an amount of money equal to the amount,
> if any, that any Put proceeds received by Exempt-Org are less than
> \$1.3 million.

>

> In this way, Exempt-Org is assured of getting the
> cash BUT the assurance does not come from S Corp. Shouldn't this
> eliminate the above concerns. Doesn't it also have the effect of
> helping Exempt-Org; to wit, if the Put is exercised at \$1 million then
> Shareholder must give \$300,000 to Exempt-Org. Isn't this \$300,000
> clearly a charitable gift so that Exempt-Org has no UBIT issues
> whereas the redemption proceeds may be UBIT.

>

Thoughts. Let's talk on Friday.

>

>

-----Original Message-----

From: Manth, Larry E

Sent: Wednesday, March 15, 2000 12:53 PM

To: Bailine, Richard W

Cc: Smith, Richard H (WNT); Galbreath, Phillip

> L; Springer, Mark A; Peters, Marsha F; Atkin, Andrew S; Duncan,
> Douglas P; Huber, Robert

3041

> Subject: S-corp Product
>
> Rick, please see my comments below.
>
> Thanks, Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 4:49 PM
> To: Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Peters, Marsha F
> Subject: FW: S-CAEPS
>
> Below are Rick Bailine's comments relating to the
> Sub C issues in the S-CAEPS whitepaper.
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 13, 2000 7:29 PM
> To: Galbreath, Phillip L
> Cc: Bloom, Gilbert D; Springer, Mark A; Peters,
> Marsha F
> Subject: RE: S-CAEPS
>
> Phillip--I have read the attached and have the
> following comments related solely to Sub Chapter C.
>
> 1. This appears to be little more than a old give
> stock to charity and then redeem it play and as pointed out in the
> write-up at footnote 51, the IRS has, for the most part, thrown in the
> towel on these (despite a strong record in court). Having said this
> please read on:
>
> [Manth, Larry E] Yes, very similar, but during the
> time the tax-exempt owns the stock it will be allocated 90% of the
> income, be paid no distributions, and be redeemed for a small value.
>
> 2. I think the section 269 discussion is weak. It
> seems clear to me there is an acquisition of control by Exempt-Org as
> it acquires 90% of the number of shares of the S Corp and even if
> discounted at 35% (which would be questionable I think) for lack of
> voting rights as discussed in the write-up at footnote 4, this 90% of
> the number of shares should have >50% of the value of the S Corp (90%
> times 65%=58.5%). Thus, I think the argument is that (i) Exempt-Org
> receives no tax benefit from the acquisition of control, its tax
> benefits stem from its status under section 501 and (ii) the S Corp
> gets no tax benefit from the acquisition of control as its tax
> benefits stem from its status under section 1361 et seq. Thus, the
> acquisition of control is not material to any tax benefit. The
> write-up does go down this path but spends more time arguing that
> there is no acquisition of control which I think is a mistake. Also,
> the write-up speaks in very conclusive terms when it should be using
> words like "should not apply" as opposed to "...section 269 does not
> apply...". See page 7.
>
> [Manth, Larry E] See revised technical paper
> attached. Please note that the way the transaction is structured, the
> non-voting stock will not be greater than 50% of the value of the

> S-corp (the warrants significantly dilute the value).

>

> 3. My biggest concern is the redemption right given
> to Exempt-Org; why does this right guaranty Exempt-Org will receive
> cash equal to the greater of FMV at time of redemption versus FMV at
> date of gift? This right takes all downside risk away from Exempt-Org
> and one of the hallmarks of ownership is that the owner inherits the
> "benefits and burdens" of ownership. By relieving Exempt-Org of the
> burden of downside risk are we not allowing IRS an alternative
> argument that Shareholder did NOT give S Corp stock to Exempt-Org,
> rather what was truly given was a right to a fixed amount of cash plus
> a SAR (Stock Appreciation Right).

>

> At page 11, the write-up discusses the potential
> issue that the warrants may be stock and in this light looks at Rev
> Rul 82-150. As for the analysis on this point, I think the write-up is
> fine but this revenue ruling also clearly tells us that if one is to
> be viewed as the owner of equity, one must assume the risks associated
> with equity ownership. Traditionally, one such risk is the risk the
> equity investment will decrease in value. Exempt-Org has no such risk
> and, therefore, arguably may not be viewed as an equity owner.

>

> Moreover, why is this downside protection either
> necessary or desirable? I would think giving Exempt-Org a right to
> demand redemption (i.e. a "put") at FMV as of the date of exercise of
> the put, is more in keeping with the desires of Shareholder and
> Exempt-Org gets a windfall even if it get one cent! It would also seem
> that put at FMV as of date of exercise is truly in keeping with the
> requirements of Treas Reg 1.1361-1(l)(2)(iii). See footnote 20, page
> 6.

>

> [Manth, Larry E] The reason we guarantee the
> tax-exempt a minimum is that there is a potential burden -- federal
> taxes. It is not a certainty that the tax-exempt is totally exempt
> from tax on holding the stock. Also, very few tax-exempts would ever
> take this stock because of the UBIT concerns. So we are using the
> floor as an incentive for the tax-exempts to take the stock.
> Hopefully the discussion under economic substance regarding beneficial
> ownership on pages 12 through 19 will suffice in addressing your
> concerns on ownership issues;

>

> << File: S_Corp_Strategy.doc >>

>

> Let's chat.

>

> -----Original Message-----

> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 2:46 PM
> To: Bailine, Richard W
> Subject: FW: S-CAEPS

>

> Attached below is the most recent version of the
> S-CAEPS whitepaper. As I was telling you, this Tax Solution is
> getting some very high level (Stein/Rosenthal) attention. Please
> review the whitepaper as soon as possible and provide your comments to
> Larry Manth directly. Please copy Richard Smith, Mark Springer, Marsha Peters, and me
> on your message to Larry. Thanks for your help.

>

> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162

>

KPMG 0016530

3043

> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Sunday, March 12, 2000 10:35 AM
> To: Watson, Mark T; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
> Cc: Atkin, Andrew S; Duncan, Douglas P; Huber,
> Robert
> Subject: RE: S-CAEPS
>
> Mark, thanks for your comments. I will address each
> one separately.
>
> 1) Assignment of Income Issues. We have included
> an additional paragraph under the assignment of income section. But
> also see the economic substance arguments. Bill Kelliher
> substantially enhanced that section and it addresses many issues,
> including beneficial ownership and income allocation.
>
> 2) No charitable or gift tax deduction and
> reallocation of income back to original shareholders. Again, I think
> the economic substance arguments cover these issues. But I am not
> convinced that the Service would be successful in disallowing a
> charitable deduction. After the transaction, the tax-exempt will have
> cash based on the fair market value of the stock. It does nothing but
> hold the stock. The split-dollar transactions have the tax-exempt buy
> insurance. Also, this transaction is quite similar to the charitable
> FLP. Is this a concern for that transaction as well?
>
> 3) Per Larry DeLap's E-mail, we are not discussing penalty issues.
>
> 4) Self-Dealing Issues. We have inserted a
> discussion on section 4958, drafted by our EXO-Tax group in D.C. We do,
> however, plan on using only 401's.
>
> Larry
>
>
> << File: S_Corp_Strategy.doc >>
>
>
> -----Original Message-----
> From: Watson, Mark T
> Sent: Friday, March 10, 2000 8:24 AM
> To: Manth, Larry E; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
> Subject: S-CAEPS
>
> OK. I have reviewed the revised S-CAEPS white paper
> and I am still not convinced that the assignment of income issues
> associated with this strategy and the ramifications of Notice 99-36
> have been adequately addressed and/or considered. The assignment of
> income discussion in the white paper is very brief and contains little
> case law analysis. While the conclusion reached in the white paper on
> this matter may very well be correct, the brief discussion contained
> in the white paper does not give me a tremendous amount of comfort
> that all of the relevant cases and rulings have been considered,
> particularly wrt whether or not the Shareholder is assigning the S
> corp's earnings to the Exempt Organization.
>
> More importantly, the paper's discussion of Notice
> 99-36 seems to miss the point. Yes, we can certainly distinguish the

3044

> S-CAEPS transaction from the transaction that was the subject of
> Notice 99-36, but my point in raising Notice 99-36 is to make sure
> everyone is aware of the potential downside of this transaction. If
> the Service comes after the S-CAEPS transaction the way it attacked
> the Charitable Split-Dollar transaction (and I believe Notice 99-36
> and the recent section 643(a)(7) regulations indicate it will),
> clients who enter into the S-CAEPS transaction could be faced with a
> situation where: (1) they don't get an income OR gift tax charitable
> contribution deduction for the contribution of the S-Corp stock to
> charity (and, thus, they may incur a substantial gift tax liability);
> and (2) they are required to recognize all or most of the S corp's
> earnings. Further, as stated in Notice 99-36, the Service may attempt
> to impose a variety of penalties on the participants in this
> transaction (including KPMG) including the penalty under section 6701
> for aiding and abetting the understatement of tax liability. Finally,
> the white paper contains no discussion as to why the Service cannot
> claim the S-CAEPS transaction involves private inurement, an
> impermissible private benefit, or self dealing, all issues raised in
> Notice 99-36. Perhaps if the "Exempt-Org" is a section 401(a) entity rather than a
> section 501(c)(3) entity these issues go away. If so, the
> white paper should so indicate.
>
>
> Mark T. Watson
> Partner
> KPMG - Washington National Tax
> 202-533-3092 (phone)
> 202-533-8451 (fax)
>

3045

From: US-Tax Innovation Center
Sent: Wednesday, April 10, 2002 3:56 PM
To: Atkin, Andrew S; Manth, Larry E; Huber II, Frank E; Duncan, Douglas P; Schrier, John V; Speiss, Timothy P; Silver, Lawrence G; Duty, James V; Leak, Council; Gray, Michael W; Terracina, Michael P; Warley, Carol G; Pence, Robert M; Cohen, David (US/CHICAGO); Hutchison, Mark-Warner Cntr; Wise, Richard; Affonso, Dale A; Busick, Ronald L; Einhorn, David J; Ellis, Craig A; Jackman, Thomas E; Krutilla, Gary M; Logan, Kelly F; Morris, Craig S; Pichette, Craig L; Plescia, Perry V; Powell, Gary N; Rivkin, David; Robinson, Jonathan J; Schorr, Eugene G; Skrip, Martin J; Tom, Randall G; Ammerman, Douglas K; Curran, John D; Forsythe, Duncan M; Horan, James L; Hutchison, Mark-Warner Cntr; Ito, Dennis A; Jackman, Thomas E; Johnson, Peder R; Leak, Council; Logan, Kelly F; Mahoney, Michael P; Manth, Larry E; Pence, Robert M; Pichette, Craig L; Rauls, Stephanie D; Silver, Lawrence G; Skrip, Martin J; Speiss, Timothy P; Terracina, Michael P; Tom, Randall G; Walla, Michael E
Cc: Brockway, David H; Gremminger, Steven L; Jones, Ken-WASH-DC; Chopack, John J; Ely, Mark H; Miller Jr., Norlyn D; Lewis, Harve; Springer, Mark A; Peters, Marsha F; Duer, Walter M
Subject: IRS Summon Information Request for SC2
Importance: High
Sensitivity: Confidential

**THIS IS SENT AT THE REQUEST AND DIRECTION OF THE OFFICE OF
GENERAL COUNSEL KPMG LLP.**

PRIVILEGED AND CONFIDENTIAL

TO: SC2 Deployment Team and selected Tax Service Partners

The IRS has requested certain information from the Firm relating to SC2. WNT and the Office of General Counsel are evaluating the IRS request and will determine the appropriate course of action. In the meantime, we need your assistance in gathering certain information with respect to all implemented SC2 engagements. Attached are two lists of clients that we believe purchased this solution -- one list compiled from OMS, and the other taken from the Engagement Information Form (EIF) system data. The EIF list contains the specific data points that we must collect. One new field not previously collected, and which is critical to the initiative, is the "Year Implemented". For SC2 that is the date the trust was funded

FOR YOUR ACTION:

1. Please review both lists -- if the OMS list includes a booked or completed transaction that was implemented (as defined above) after December 31, 1997 and is not on the EIF list, you must complete an EIF for that engagement. If not yet implemented, do not enter a date.
2. If an entry on the EIF list includes missing information, you must provide that information. In the "TSA name" field enter SC2, even if the solution was not the

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 11

XX-001433

subject of a Tax Solution Alert (TSA). You can access the EIF system using the control # designated on the EIF list for the respective engagement - select "Update Existing EIF". (Alternatively, you may update the information on the attached spreadsheet and forward it to the US-Tax Innovation Center inbox-we will update the associated EIF for you. Please underline the changes on the spreadsheet or otherwise clarify what changes you made.)

3. Finally, if you are aware of engagements implemented (as defined above) after December 31, 1997 that are not reflected on either of the attached lists, you must complete an EIF for those engagements.

The link to the EIF system is: <http://r&d/EIF_RD/EIF_Edit.htm>.

Also attached is a letter that must be sent to all clients that implemented (as defined above) SC2 after December 31, 1997.

Please verify via a reply e-mail message no later than Thursday, April 11, 2002, that to the best of your knowledge you have provided all the requested information regarding implemented engagements.



SC2EIFReport.xls
s



SC2 Booked
Deals.xls



Disclosureletter-
ummonsRev.do..

Meeting Minutes – Monetization Solutions Task Force Teleconference

2:15 pm to 3:30 pm EST – November 30, 2000

Teleconference discussion attendees were T. Speiss, D. Baumann and R. Bickham.

The next teleconference is 10:30 am EST on 12/7/2000.

The purpose of the teleconference was to continue a discussion of the development of a revised business model for the Innovative Strategies (IS) Practice, based upon preliminary dialogue in an IS Lab meeting held on November 17, 2000. On that date a Task Force was formed with the above persons with T. Speiss as Task Force Leader.

A summary of the discussion follows

Discussion Agenda

1. General Overview of the KPMG U.S. Personal Financial Planning Practice(PFP)
2. Current Business Model of The Innovative Strategies (IS) Practice
3. Factors Causing a Change in The Current IS Business Model
4. Preliminary Steps in Implementing The New IS Business Model – 30 Days
5. Additional Tools, Human Resources and Additional Deployment Assets Needed to Implement The New IS Business Model

**Proprietary Material
Confidentiality Requested**

KPMG 0050624

**Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 48**

1. General Overview of the KPMG U.S. Personal Financial Planning Practice (PFP)

The IS practice is a component of KPMG's U.S. PFP practice. The PFP practice's services are targeted at the high wealth individual marketplace, in addition to large employer groups, Fortune 500 entities and shareholders of large privately held entities. PFP clients include the affluent, e-commerce entrepreneurs, C-Class executives, corporate founders, professional athletes, entertainers, professional sports teams, and employees of successful new economy/old economy entities. PFP relationships have been valuable in helping to drive additional revenue opportunities for KPMG.

The PFP practice's primary lines of service in the United States are Innovative Strategies, Corporate Programs, Investment Advisory and Core Tax. Additional PFP service lines include Family Wealth and other specialty services. There is a focus on PFP professionals to practice within specific services lines to drive KPMG revenue, as can be seen by the IS, Corporate Programs and Investment Consulting Group specialty structure within PFP.

The IS practice focuses on the design, deployment and implementation of sophisticated and complex high value income and transfer tax solutions. These solutions, at times uniquely customized, have also included financial product consulting and design components. PFP's Core tax and financial planning includes more traditional income and transfer tax planning; investment asset allocation, assistance with money manager selection and investment asset performance monitoring; insurance/risk management consulting; cash flow planning; life event planning including corporate change-in control transactions, and retirement and education funding; equity compensation consulting and design; outplacement and separation consulting and related services including tax compliance and planning.

In most U.S. operating offices, the PFP practice's marketplace strategy is tailored to the economics and businesses that drive those markets, hence the national PFP business plan must be flexible yet comprehensive in order to capture appropriate opportunities. As an example of this strategy, in certain U.S. offices, the PFP practice services larger closely held businesses, and in addition to consistent annuity income being generated from the Core Services to these entities' owners/shareholders, these clients have generated significant IS revenue opportunities for KPMG. Alternatively, in certain U.S. offices, the PFP practice has been successful with Corporate Program services generated from larger public corporate entities, likewise these relationships have generated significant IS revenue opportunities. Frequently, the PFP practice designs and delivers its services in coordination with other KPMG practices such as the Compensation and Benefits and the Federal Tax Practice. An example of this joint go-to-market distribution and deployment synergy is SC2 and Option Diversification Vehicle (ODV) and initiatives with Executive Suite. Currently, the PFP practice is beginning to develop a business plan with regard to delivering international tax/PFP services. In this regard, in certain offices and markets in the U.S. and abroad, PFP is working with the International Executive Services (IES) Practice to deliver U.S. and foreign country income and transfer tax services, deployed with the appropriate technical review and KPMG inter-office cooperation, integrated with traditional PFP services.

2. Current Business Model of The Innovative Strategies (IS) Practice

When reviewing IS revenue generated as a component of total PFP revenue in the fiscal years ending in 1996 through 2000, IS gain mitigation solutions have been a primary driver and contributor to both top line and bottom line success. The IS practice over the years has offered and implemented a diverse array of premium solutions for clients that has not been exclusively gain mitigation. These solutions have been designed and implemented to attain both income and transfer tax planning objectives, and have included deferral techniques, as well as investment opportunities. Clients have however historically requested gain mitigation solutions. Since the current landscape has significantly impaired both the client appetite and the IS practice's ability to effectively design and implement these gain mitigation solutions, IS revenue forecasts based upon the current model have been significantly downgraded. This revenue forecast is being experienced by other KPMG practices, also due to the current landscape.

3. Factors Causing a Change in The Current IS Business Model

There are a number of outside factors that have made the success of the IS model difficult to replicate. The most significant factor has been an active U.S. Treasury policy publicly targeting loss mitigation transactions and solutions, as witnessed by Notice 2000-44 released on August 11, 2000. In addition, Internal Revenue Service (IRS) tax shelter regulation projects, including list maintenance requirements, and court cases focusing on forcing taxpayers to demonstrate transaction business purpose and investment and profit motive, have all converged, creating an environment and landscape that has significantly dampened the ability to generate IS revenue and profit levels that have been historically attained with primarily gain mitigation solutions. The chaos of the current environment however, can create opportunity for KPMG.

4. Preliminary Steps in Implementing The New IS Business Model – 30 Days

In creating a new IS business model, there is the opportunity to expand current IS services beyond the tax technology that the current legislative environment has stifled. The new business model will focus on services that give our clients a broader choice of options, and where the KPMG IS professional delivers value as a wealth advisor and not primarily as a tax advisor. The KPMG IS wealth advisory role will lead with introducing and educating our clients as to their alternatives and opportunities beyond tax strategies, by leading with and incorporating solutions for our clients that are financial product based. These financial product-based solutions will include monetization solutions that have been traditionally offered by the investment banks, but that can be designed and engineered by KPMG IS. We are exploring other KPMG practices to work with in this regard to augment the IS skill set. The goal is to start generating revenue now for 6/30/01.

The role of an IS wealth advisor, once the requisite skill set has been attained, is to be able to discern the client's goals, objectives and risk temperament, as we do now as advisors, but to help the client analyze and understand the benefits and consequences of available and customized financial products, for example the workings of a prepaid forwards, puts and calls, short sales, synthetic OID conveyances, and other derivative structures, and the economic assumptions and forward and present value interest rates, and to then be able to compare these structures to innovative tax solutions, for example CTF, IDV, Private Exchange Fund, Private Prepaid and other solutions, all geared to help the client select the best alternative that maximizes their wealth over a time horizon considering their risk tolerance and all other appropriate factors. The result of this business plan approach, based on an investment banking model, is to expand our services beyond tax solutions, provide greater choice to the client with regard to goal attainment, and focus on a lasting client relationship where we are acting as their long-term chief financial officer with regard to the design, implementation, and monitoring of sophisticated entity structures that have elements of both financial product technology and tax technology. We will continue to promote the KPMG brand name, emphasizing independence and objectivity, creativity, innovation and quality design. Longer term, we want to be able to cite a deeper breadth of KPMG resources or/and relationships in the financial product area. The current IS structure will otherwise remain intact for now.

Typically, it is contemplated we would be working with clients in advance of any liquidation transaction, presumably where they own a concentrated investment position(s) with a built-in gain of at least \$ 50 million.

In the marketplace there will be competition, however if we have relationships where we are viewed as creating opportunity for the investment banks with regard to the ability to monetize a concentrated position, and we can work together with the investment banks on financial product implementation and even share the ability to monitor/advise with regard to assets (Stratis), it is anticipated we will not dampen our current investment bank referral base. Our advantage will be our independence as we are able to analyze different product offerings economic assumptions and costs among the banks, where we are not able to place or implement an investment strategy ourselves.

Specific Preliminary Steps – Short Term Action Points – Discuss with Jeff Eischeid

1. Tim to accumulate KPMG white paper discussions on financial products solutions that we can implement immediately. These product solutions as a "Monetization Suite" could include
 - a. Synthetic OID Conveyance Strategy (SOCS)
 - b. 21st Century (SOCS)
 - c. SLEEK
 - d. Private Prepaid
 - e. Private Exchange Fund
 - f. CEDS
 - g. CELS
 - h. Other
 - i. In addition, selected Innovative Solutions (Tax) should be considered as offerings
2. Dale and Randy to develop marketing materials considering the solutions cited in 1. above. In addition, create communication pieces.
3. Dale, Tim and Randy Identify an external resource(s) that could work with us to inject financial product knowledge immediately into the process as we now consult with clients. Note T. Speiss Boston client as a test case. Considerations include representatives from Bear Stearns, Montgomery Securities, other. Specific names were discussed.
4. In addition to 3. above, Dale, Tim and Randy to identify internal resources that could work with us to inject financial product knowledge immediately into the process as we now consult with clients. KPMG resources would be especially useful in teaching/educating IS PFP team members as to the strategies and more fundamental components, as well as to help identify other financial product solutions in the marketplace, their applicability, analyzing assumptions, other matters. Specific names were discussed.
5. In addition to 1. and 2. above, continue to work on software tools to depict economics of the alternatives and compare the alternatives. SLEEK and basic prepaid model is complete, CELS is in progress. Tim and David Kohn to continue this process.
6. Dale, Tim and Randy Identify a team of eight to ten KPMG (IS) persons who would be on the task force and would serve as initial beta test Monetization Suite Team members. These persons would become responsible to learn the appropriate financial product solutions, attend any initial training courses, invest the requisite time to be a productive team member, meet with clients of other KPMG offices,

control and direct the information and investment process, be able to explain complex structures and transactions, respond to client questions, meet with investment bankers and boutique firms, learn other solutions in the marketplace, help/lead the implementation process wrt the solutions, work with other IS team members to identify client opportunities. It was discussed having five members from the Northeast area and five members from the West Coast area.

7. We have begun to think about a meeting of the persons identified in 6. above, once steps 1. through 5. are complete (optimally, within 30 days from 12/4/2000).
8. The current IS structure would remain in place unchanged for the time being. The Monetization Suite Team would be created as a component of IS until decided otherwise. We need focus on all IS as cited in the lab meeting of 11/17/2000 (SC2, ODV, LPSP, BIGS, ACDS, IDV, CTF, Other)
9. While the capital markets are volatile and we are approaching year end, the next 45 days could be a prime time to start this initiative

5. Forthcoming after 12/7/2000 Teleconference: Additional Tools, Human Resources and Additional Deployment Assets Needed to Implement The New IS Business Model

From: Manth, Larry E
Sent: Monday, April 08, 2002 11:45 AM
To: Adams, Mark; Alvarez, Adele M; Atkin, Andrew S; Bergmann, Jeffrey K; Black, Suzanne J; Boyar, Adam W; Coughlin, Sean S; Cozart, Toby; Crippen, Richard R; Curtis, Gary L; De La Hoya, Raquel M; DeCredico, David G; Dougherty, Timothy M; Duncan, Douglas P; Frimmershein, Oleg; Gantman, Andrew; Gergen, Patricia A; Gilman, Seth F; Giordano, Anthony V; Greenberg, David; Gurrila, Kenneth W; Hansen, Joe (US/Sacramento); Harrison, Mark E; He, Mark (Yizhou); Hill, James A; Hirata, Masanori; Huber, Robert; Hughes, Ian D; Hussain, Selwa; Hutchison, Mark-Warner Ctr; Ida, Walter Y; Jackman, Thomas E; Kadekian, Sandy M; Kamahale, Dean B; Kreutzer, Conrad B; LaRocca, Leonard J; Lauro, Phillip J; Lyle, Norman W; Mathis, Timothy D; Matsuura, Ann Y; McIntyre, Jeannie; Morris, Craig S; Orshensky, Anthony J; Park, Jasmine J; Perez, Frank; Prager, Daniel; Roubideaux, Robert W; Robinson, Christopher J; Ryan, Susan E; Shen, Stephanie L; Shepherd, John; Sparkman, James; Tatro, Angela M; Turski, Douglas A; Wilkins, Roger A; Wilson, John H; Wong, Janet S (US/Silicon Valley)
Subject: FW: Statecon Final Results for March 2002

National Statecon March MTD Results

March FY'02 (Period 6)							
	Southwest	Midatlantic	Northeast	Midwest	Southwest	Western	Other
Mar '02 Revenue	\$856,794	(\$2,830,653)	\$448,430	\$987,818	\$498,761	(\$705,325)	\$1,245
Mar '02 Oper Exp	\$726,539	\$115,427	\$381,127	\$382,288	\$311,637	\$819,478	\$12,919
Mar '02 Oper Inc	\$130,254	(\$2,946,080)	\$67,303	\$605,530	\$187,124	(\$1,524,803)	(\$11,674)
Mar '02 Oper Margin	15.2%	104.1%	15.0%	61.3%	37.5%	216.2%	0.0%
Plan Revenue	\$1,198,960	\$333,161	\$1,813,645	\$1,194,760	\$828,726	\$1,613,034	\$0
Plan Oper Exp	\$344,323	\$73,086	\$595,139	\$265,025	\$217,382	\$636,105	\$0
Plan Oper Inc	\$854,637	\$260,075	\$1,218,506	\$929,735	\$611,344	\$976,930	\$0
Plan Oper Margin	71.3%	78.1%	67.2%	77.8%	73.8%	60.6%	0.0%
Rev vs Plan	(\$342,167)	(\$3,163,814)	(\$1,365,214)	(\$207,142)	(\$329,964)	(\$2,318,359)	\$1,245
Oper Exp vs. Plan	\$382,216	\$42,341	(\$214,012)	\$117,263	\$94,255	\$183,373	\$12,919
Inc vs Plan	(\$724,383)	(\$3,206,154)	(\$1,151,203)	(\$324,405)	(\$424,220)	(\$2,501,732)	(\$11,674)
							(\$8,343,770)

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 50

XX-001732

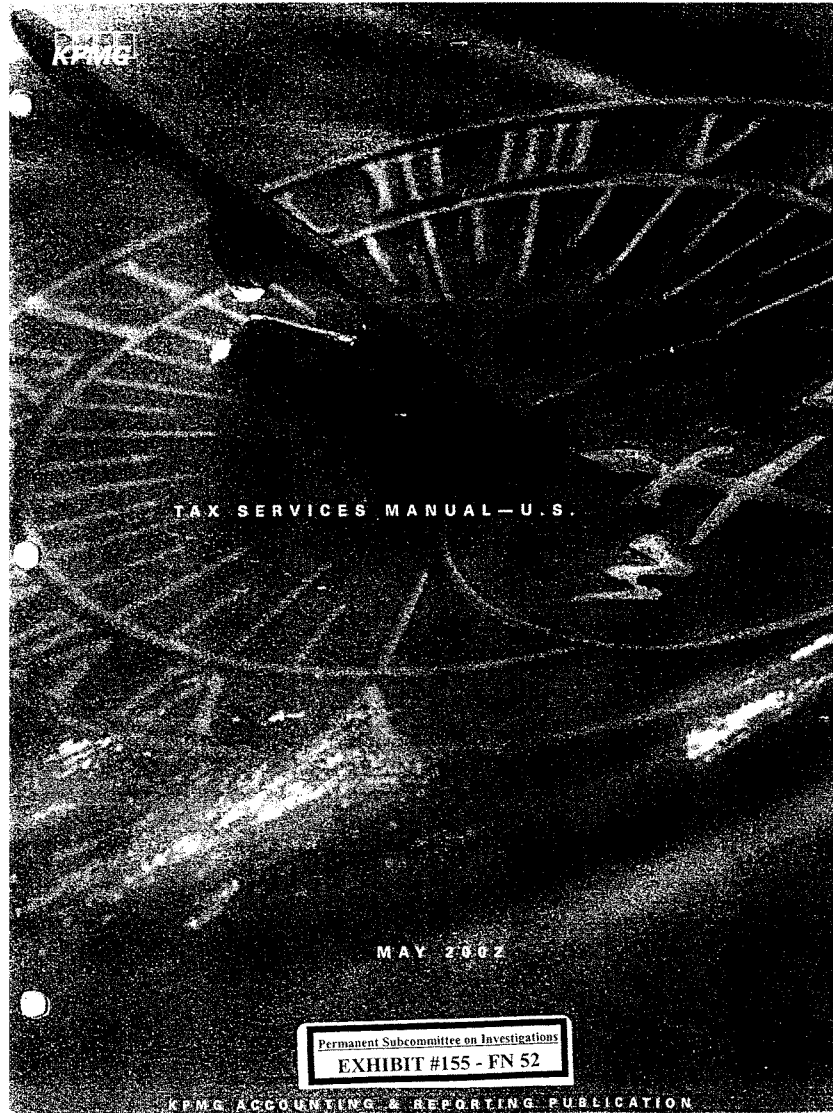


Table of Contents

Part I—Overview

1. How To Use the *Tax Services Manual—U.S.*
2. National Resources—Tax

Part II—Practice Management

20. Tax Quality Performance Reviews
21. Professional Licenses
22. Conflicts of Interest
23. Speaking Engagements and Published Material
24. Tax Solution Development and Deployment

Part III—Tax Engagement Procedures

30. Client Evaluations and Terminations
31. Tax Engagement Letters
32. Fee Arrangements
33. Tax Engagement Responsibilities and Files
34. Large Case Project Management
35. Confidentiality, Exclusivity and Privacy
36. Engagement Information Form
37. Foreign Tax Advice and Multi-firm Engagements

Part IV—Tax Compliance and Tax Consulting Services

40. Tax Compliance Engagements
41. Correspondence, Memoranda and Opinions
42. Use of Certain KPMG Professionals in Tax Engagements
43. Loaned Staff and Outsourcing Engagements
44. Tax Personnel Involvement in Accounting Matters
45. Independence Considerations Associated With Tax Services

Part V—Dealings With Third Parties

50. Client and Third-party Access to Tax-related Materials
51. The Practice of Law and Other Legal Matters
52. Tax Services Alliances
53. Use of Subcontractors
54. Relationship With KPMG Consulting, Inc.

Part VI—Dealings With Tax Authorities

60. Tax Examinations, Tax Protests and Requests for Technical Advice and Ruling Requests
61. Privileges
62. Penalties, Other Sanctions and “9100” Relief

May 2002

- 63. Tax-related Litigation Services
- 64. Tax Legislative Activities

Appendix A—Federal Tax Protest—Transmittal Form

Appendix B—Citations Guide

Part I—Overview

In this Part This part contains two chapters:

Chapter	Title
1	How To Use the <i>Tax Services Manual—U.S.</i>
2	National Resources—Tax

Chapter 1—How To Use the *Tax Services Manual—U.S.*

1.1 General

- 1.1.1 This manual defines firm policies for providing tax services and gives guidance on applying these policies.
- 1.1.2 This manual is proprietary and confidential and contains trade secrets. It is not to be disseminated in whole or in part to anyone outside of KPMG LLP (KPMG). This manual is intended to assist our professionals in rendering quality tax services in a manner consistent with professional standards and risk management considerations. It cannot and is not intended to be a substitute for the exercise of discretion and professional judgment.
- 1.1.3 Personnel of KPMG adhere to the ethical and professional standards and rules and regulations of the accounting profession. In places, the guidance in this manual exceeds the minimum standards set by the profession in order to provide guidance and instruction to our professionals that will enhance the high quality of service provided to our clients. This manual, however, is not intended to subject KPMG or its personnel to a standard of care externally that is higher than the standard to which other accounting professionals are held.

1.2 Tax Policies

- 1.2.1 A summary of tax policies for each chapter appears in a shaded box at the beginning of the chapter. Policies are repeated in relevant subsections as appropriate. Exceptions to policies, if any, are noted in the relevant subsections.

1.3 Tax Guidance

- 1.3.1 Each chapter includes text that appears in numbered paragraphs that further explains the policies and provides guidance on rendering tax services.

1.4 Other Firm Manuals

- 1.4.1 Other firm manuals include the:
- *BMP Methodology Guide*—sets forth firm policy and guidance for the Business Measurement Process (BMP).
 - *Due Diligence Assistance Guide (DDAG)*—sets forth firm policy and guidance for due diligence services.
 - *KPMG Audit Manual—U.S. (KAM—U.S.)*—sets forth firm policy and guidance for audits of financial statements and certain other assurance service engagements.
 - *MD&A Methodology Guide (MD&A MG)*—sets forth firm policy and guidance for attestation engagements that examine or review management's discussions and

May 2002

analysis (MD&A) of public and nonpublic entities prepared pursuant to the rules and regulations adopted by the Securities and Exchange Commission (SEC), which are presented in annual reports to shareholders and in other documents.

- *Reports Manual (RM)*—sets forth firm policy and guidance for reporting on assurance services, including audits, reviews, compilations, agreed-upon procedures, and attestation and other services.
- *Risk Management Manual—U.S. (RMM—U.S.)*—sets forth firm policy and guidance for professional practice matters.
- *SEC Manual (SECM)*—sets forth firm policy and guidance for the firm's SEC engagements, including the required review by an SEC reviewing partner.
- *Single Audit Manual (SAM)*—sets forth firm policy and guidance for single audits and program-specific audits.

1.4.2 This manual references these and other firm manuals as appropriate.

Chapter 2—National Resources—Tax

2.1 Department of Professional Practice—Tax (DPP—Tax)

- 2.1.1 The Department of Professional Practice—Tax (DPP—Tax) supports the tax practice in providing quality tax consulting and compliance services to our clients. It facilitates understanding and compliance with firm policies and procedures. A directory of the Department of Professional Practice—Tax professionals is maintained on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

The Department of Professional Practice—Tax addresses the following broadly defined areas:

- reviews new tax service offerings from a professional practice and risk management perspective;
- reviews contingent fee arrangements for tax engagements;
- evaluates and approves tax alliance relationships with the vice chairman—tax services and with the management committee (for Level 2 alliances) after consultation with the Strategic Alliance and New Ventures practice and the Office of General Counsel (where appropriate);
- evaluates and approves tax multiple-party opinion engagements;
- develops and conducts firmwide tax professional practice training;
- recommends changes in firm policy to the tax leadership team;
- issues timely information to tax personnel on changes in firm policy and procedure;
- coordinates with the Department of Professional Practice—Assurance (DPP—Assurance) on such issues as interpretation and application of accounting pronouncements directly relating to income tax expense (FAS 109);
- acts as liaison with other firmwide support functions (e.g., DPP—Assurance, Office of General Counsel, Client Service Technology and Washington National Tax);
- consults on existing and emerging professional practice issues; and
- oversees annual interoffice and intraoffice quality performance reviews of tax services.

May 2002

2.2 National Solution Group Professional Practice Partner—Tax

- 2.2.1** The national solution group professional practice partner—tax coordinates compliance with professional practice and risk management policies within that solution group and helps to develop professional practice procedures that are unique to that solution group. A current list of national solution group professional practice partners—tax is maintained on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

2.3 Business Unit Professional Practice Partner—Tax

- 2.3.1** The business unit professional practice partner—tax provides professional practice leadership with respect to tax services and oversees adherence to related firm guidance and professional standards at his or her assigned business unit(s). A current list of business unit professional practice partners—tax and their assigned locations is maintained on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

- 2.3.2** With respect to tax services provided in his or her business unit, the business unit professional practice partner—tax:

- reviews with each tax services partner the annual risk assessment of existing clients;
- approves a partner or tax managing director candidate;
- reviews and approves, where appropriate:
 - modifications of the “Standard Terms and Conditions—Tax Engagements,”
 - requests to pay taxpayer penalties on a client’s behalf,
 - correspondence to taxing authorities asking for relief from penalties where there is a possibility the client may hold KPMG responsible for the penalties,
 - modifications to the Department of Professional Practice—Tax’s preapproved engagement letters,
 - engagement letters with value-added fees that have not been preapproved by the Department of Professional Practice—Tax,
 - agreements to keep client and/or third-party information confidential;
- is copied on contingent fee and value-added fee engagement letters;
- oversees compliance with professional licensing requirements;
- provides guidance on conflicts of interest in tax matters;

- approves loaned staff engagements before a commitment is made to a client to provide loaned staff;
- monitors Engagement Information Form submissions;
- monitors compliance with Tax Knowledge Sharing policy and procedures;
- coordinates with the business unit professional practice partner—assurance regarding independence and other firmwide professional practice matters;
- identifies emerging tax professional practice issues and problems and promptly takes appropriate action;
- monitors compliance with the firm's record retention and destruction policy;
- provides professional practice training for new hires and an annual professional practice update to tax professionals in his or her business unit;
- determines that there is effective coordination of the tax control system (e.g., overseeing *KPMG/Atlas* and maintaining list of tax return preparers) for all tax compliance engagements;
- determines that there is effective coordination among the tax services engagement partner, Office of General Counsel and the Department of Professional Practice—Tax with respect to potential or current legal actions concerning tax services provided; and
- reviews the use of a claim of exclusivity in a presentation, ICV or feasibility letter, or engagement letter for a non-audit client, with respect to an income tax strategy that may result in a corporate federal income tax benefit.

2.3.3 Where business unit professional practice partner—tax approval is required and the engagement team encompasses more than one business unit, approval is sought from the business unit professional practice partner—tax for the business unit to which the tax engagement partner is assigned.

2.3.4 For those instances (e.g., approving prospective client evaluations, approving modifications of the Standard Terms and Conditions—Tax Engagements or approving a partner or tax managing director candidate) where the business unit professional practice partner—tax's approval is required and the engagement partner for the underlying client or the sponsoring partner is the business unit professional practice partner—tax, it is not appropriate for the business unit professional practice partner—tax to give approval. Where such a conflict exists, the business unit professional practice partner—tax seeks approval from the business unit professional practice partner—tax in an adjacent business unit.

May 2002

2.4 Office of General Counsel

- 2.4.1 The Office of General Counsel provides legal counsel to the firm and its partners, including counsel with respect to the investigation and defense of actual and threatened litigation.

2.5 Tax Leadership Team

- 2.5.1 The tax leadership team comprises the vice chairman—tax services, vice chairman—tax operations, area managing partners—tax, national service line leaders, tax industry leaders, and tax infrastructure. It also includes representation from other members of the Americas tax practice, Canada and Latin America.
- 2.5.2 The tax leadership team meets periodically (videoconference or face-to-face) with a focus on both strategic and operational issues facing the tax practice. This team is responsible for driving the growth and profitability of the tax practice and implementing the strategy. Owing to its members, the team is able to reach decisions with full consideration of geographic, functional, industry and infrastructure issues.

2.6 Vice Chairman—Tax Services

- 2.6.1 The vice chairman—tax services is charged with setting the long-term strategic direction for the tax practice and driving performance to meet the stated goals. This includes:
- expanding the practice into new areas that reflect the ever-changing marketplace;
 - overseeing the development and deployment of tax solutions to meet our clients' business needs;
 - assuming fiscal responsibility for the tax practice;
 - driving the hiring of direct entry partners;
 - ensuring that we provide the highest level of service to our Americas and Global Accounts; and
 - positioning and integrating the tax practice with the other functions to advance firmwide initiatives.

This individual serves as a member of the management committee.

2.7 Vice Chairman—Tax Operations

- 2.7.1 The vice chairman—tax operations works closely with the vice chairman—tax services with specific responsibility for:
- developing financial goals and budgets for the tax practice based on input from the tax leaders and a thorough analysis of the market;

- actively managing financial performance in conjunction with the CFO and tax practice leaders;
- providing direction to the service line leaders and area managing partners to revise strategies and tactics, as performance and results warrant;
- identifying and leveraging best practices across the areas and service lines;
- identifying and recruiting top talent in the market;
- ensuring that resources are deployed to their highest and best use; and
- overseeing the implementation of the tax strategic plan.

This individual serves as a member of the management committee.

2.8 Department of Professional Practice—Assurance (DPP—Assurance)

2.8.1 The Department of Professional Practice—Assurance (DPP—Assurance) serves the firm's personnel and clients in the areas of accounting, regulatory and auditing issues and provides the following services to assist the tax practice:

- consultation on independence matters affecting tax personnel and tax services;
- accounting assistance in the development of new tax solutions and tax service ideas; and
- consultation on tax provision matters.

2.9 Washington National Tax (WNT)

2.9.1 Washington National Tax provides technical tax leadership to the firm. WNT raises the public profile and builds the reputation of the firm as a preeminent leader in tax matters. The mission statement of Washington National Tax is as follows:

Washington National Tax provides leadership and support that both enhances the reputation of the firm and increases the overall quality and depth of tax services provided to clients by the firm.

2.9.2 Washington National Tax assists in the development and enhancement of tax services for global, national and key area accounts. WNT professionals identify and distill issues that affect these priority accounts and then cultivate solutions for those clients. WNT efficiently develops and deploys solutions that are oriented toward key industries and priority accounts. The solutions complement client business objectives. WNT facilitates and participates in the sale of the solutions.

2.9.3 Washington National Tax provides technical tax leadership by delivering the highest level of support to the firm's tax professionals and clients. In responding to inquiries from firm professionals and clients, WNT personnel provide consultation and research

May 2002

→ assistance. A directory of WNT professionals by practice area is maintained on the Washington National Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/wnt/index.htm>.

- 2.9.4 Washington National Tax utilizes technology to disseminate information and enhance the technical expertise and reputation of the firm as a whole. More specifically, WNT maintains the Tax Services Single Knowledge Gateway and kpmgtax.com, to include insight and analysis, integrated with other firm initiatives.
- 2.9.5 Washington National Tax professionals cultivate and maintain liaisons with professionals in various governmental agencies and offices, such as the Treasury Department, the Internal Revenue Service National Office and the tax-writing committees of Congress. WNT professionals represent clients before the Internal Revenue Service in controversy matters and to obtain rulings.
- 2.9.6 Washington National Tax professionals also support client legislative activities. This support includes: developing legislative proposals; monitoring the status of proposals; and consulting on the political, policy, economic and technical aspects of the legislative remedies. Many WNT professionals previously held senior-level tax policy positions in the federal government and, as a result, are knowledgeable about the federal tax legislative and regulatory process and are familiar with professionals in Congress, the IRS and the Treasury Department.
- 2.10 **State Resource Network**
- 2.10.1 The firm has a resource in the tax laws of each state. The partner in charge—technical tax services for state and local tax coordinates the state resource network. A current list of professionals comprising the state tax resource network is maintained on the State and Local Tax (SALT) homepage at <http://taxkm.us.kworld.kpmg.com/homepages/salt/index.htm>.
- 2.11 **Tax Innovation Center**
- TIC 2.11.1 The Tax Innovation Center, located in Washington National Tax, serves as the firm's central resource group in support of the solution and service idea development initiatives of the firm's tax practice. Staffed with dedicated management and administrative resources under the supervision of the partner in charge of tax solution development, the Tax Innovation Center works directly with the tax service lines, marketing, WNT technical groups, the Department of Professional Practice—Tax and other tax national support and firm resources in order to: enhance cross-fertilization of solution and service idea opportunities; raise tax practice development initiatives to a consistent standard and process; and assist deployment teams in the delivery of integrated, high-value tax solutions and service ideas. A tax solution is distinguished from a tax service idea in that it generally has higher overall revenue potential and, for this reason, also has a named national deployment team.
- *
BOM? 2.11.2 A new/enhanced tax solution is generally announced firmwide through the issuance of a *Tax Solution Alert* and is frequently accompanied by a comprehensive set of support materials (including technical summary, targeting/pricing/sales plans, oral/written
- TSA's

client presentation materials and sample prospecting/engagement letters). A tax service idea is announced via a *Tax Service Idea* that is posted to the Tax Service Idea Bank, which can be searched and accessed by all tax professionals. A *Tax Service Idea* typically includes an executive summary of the idea, including who could benefit most, an outline of the service delivery approach, and technical and service delivery contacts, as well as a sample client letter, technical materials, etc.

- 2.11.3** Professionals can access the tax solution portfolio and the Tax Service Idea Bank through the Tax Innovation Center homepage at <http://taxkm.us.kworld.kpmg.com/homepages/tic/index.htm> or by conducting a search of the tax solution and/or idea toolkits on the Single Knowledge Gateway homepage at <http://taxkm.us.kworld.kpmg.com/>. In addition, through KMatch at <http://kmatch.us.kworld.kpmg.com>, professionals can identify tax solutions and tax service ideas from the entire portfolio that are most appropriate for a specific taxpayer.

U.S. Tax Practices Abroad and Other Member Firm Tax Resources

2.12 U.S. Tax Practices Abroad

- 2.12.1** U.S. tax practices abroad, located in certain major cities outside the U.S., provide U.S. tax compliance services and certain U.S. tax consulting services. In most cases, such U.S. tax practices are part of the KPMG International member firm in the particular country but may include U.S. firm personnel on assignment.
- 2.12.2** The firm also has an international executive tax network in the United States and abroad comprised of international tax services personnel who perform extensive services for international executives, such as U.S. expatriates working abroad and foreign citizens working in the United States.

2.13 International Tax Centers of Excellence

- 2.13.1** The International Tax Centers of Excellence is a network of strategically positioned tax centers staffed by KPMG International member firm tax professionals. The Centers' objective is to deliver seamless international tax services to multinational companies with operations in key markets around the world (most notably our key accounts) and to help them operate more effectively on a global scale.
- 2.13.2** The Centers work in coordination with the various KPMG International member firms and the local client service teams to enhance the delivery of tax services throughout the world through a suite of tailored and technologically innovative tax solutions. For example, the Centers specialize in advising and implementing multi-jurisdictional tax effective financing strategies. The Centers also facilitate seamless service provision by advising, as needed, on local country income and indirect tax issues and assisting in the interpretation and application of advice rendered by local offices of KPMG International member firms.

May 2002

2.13.3 Current International Tax Centers of Excellence are dedicated to the following regions/countries:

- Americas Region;
- Austria;
- Belgium and Luxembourg;
- China;
- France;
- Germany;
- Israel;
- Mexico;
- The Netherlands;
- Spain; and
- The United Kingdom.

2.13.4 In addition to the International Tax Centers, KPMG's International VAT Center offers an array of compliance and consulting services to help companies achieve tax efficiency.

2.14 Tax Technology Practice

2.14.1 The Tax Technology Practice interfaces with the vice chairman—tax services and the tax leadership team in the development, maintenance and support of firmwide tax computer applications. It also represents the tax practice to the firmwide Information Services organization. The Tax Technology Practice works with Tax Knowledge Management to support the Single Knowledge Gateway, KWorld and kpmgtax.com, and forms part of the team led by the Office of Tax Digital Transformation to implement e-commerce initiatives. It also has responsibility for licensing third-party software applications for both compliance (GoSystem RS) and tax consulting purposes.

2.15 Tax Knowledge Management

2.15.1 Tax Knowledge Management's objective is to provide the best internal knowledge management solutions to the tax practice in order to facilitate knowledge sharing and distribution. Tax Knowledge Management developed and currently maintains the Single Knowledge Gateway and manages content within several proprietary Web sites and Web toolkits.

2.15.2 Tax Knowledge Management deploys content for each of the tax practice areas as well as tax support groups in the national tax practice. Tax Knowledge Management works with these various groups within the tax practice in formulating content into Web homepages and toolkits for knowledge sharing.

2.16 Tax Knowledge Sharing

- 2.16.1** Colleagues share ideas and tax knowledge through collective thought translated into documents used for providing services to firm clients. These documents, which include tax technical information and ideas, are captured and shared with other KPMG tax professionals in an environment that does not require physical proximity or an information road map. Procedures for submitting items for Tax Knowledge Sharing are outlined in section 41.10 of this manual.
- 2.16.2** The Tax Knowledge Sharing (TKS) process begins and ends with the tax professional. Tax professionals research information used in creating tax documents. These documents are fed to the Tax Knowledge Management group, reviewed by subject matter experts, cleansed of client information, posted to the TKS database, indexed and made available to the tax professional via the Tax Services Single Knowledge Gateway.
- 2.16.3** The TKS Collection is comprised of internal tax documents including content from the PEATax database. (PEATax is a proprietary database consisting of KPMG tax technical documentation prior to 1998.) These documents are collected from tax professionals in the tax practice for a post-issuance review. Firm policy was amended in 1997 to require that an electronic copy of all technical correspondence be submitted to Tax Knowledge Sharing. Tax documents include and should be classified as one of the following types:
- research memoranda;
 - client correspondence;
 - memoranda of oral advice;
 - protests;
 - spreadsheets provided for a client's use;
 - client presentations;
 - speech outlines;
 - articles for external publication (whether published to a journal, periodical or an Internet or Extranet site);
 - comment letters to government agencies; or
 - proposals.

May 2002

2.17 Single Knowledge Gateway

- 2.17.1** The Single Knowledge Gateway (SKG) is a Web site on KWorld, KPMG's intranet, that is for the use of the entire KPMG U.S. tax practice. It is meant to be a "one-stop shopping" place for information. The Single Knowledge Gateway homepage may be accessed at <http://taxkm.us.kworld.kpmg.com/>.
- 2.17.2** The Single Knowledge Gateway was launched in January 1999 to be the sharing vehicle that provides access to knowledge generated within the firm, as well as to important tax knowledge resources from outside of KPMG.
- 2.17.3** Homepages on the Single Knowledge Gateway are designed to be area- and topic-specific places for information, including news, publications, contacts, tools and solutions, practice materials, searches, research, marketing, recruiting, training, internal and external links and collaboration. Toolkits cover information and processes for specialized services and solutions.
- 2.18 Homepages for Tax Infrastructure and Service Groups**
- 2.18.1** Infrastructure homepages include the following sections: About Us, Reference Materials, News Links and Search.
- 2.18.2** Service homepages include the following sections: About Us, Tools/Solutions, News/Publications, Lexis/Nexis customized page, Practice Administration, Links and Search.
- 2.18.3** The Infrastructure and Service Groups with homepages on the Single Knowledge Gateway are as follows:

Tax Infrastructure

- [Tax Learning and Development Information Center](#)
- [Department of Professional Practice—Tax](#)
- ▪ [Tax Innovation Center](#)
- [Tax Knowledge Management](#)
- [Tax Marketing](#)
- [Tax Technology Practice](#)
- [Washington National Tax](#)

Tax Services

- Accounting Methods
- Compensation and Benefits
- ▪ Economic Consulting Services
- Engagement Services Practice
- ▪ e-Tax Solutions
- ▪ EXOTAX
- ▪ Federal Tax Legislative & Regulatory Services
- ▪ International Corporate Tax
- ▪ International Executive Services
- ▪ Mergers and Acquisitions
- ▪ Passthrough
- ▪ Personal Financial Planning
- ▪ State and Local Tax
- ▪ Stratecon
- * ▪ Strategic Alliance and New Ventures
- Tax Controversy Services
- Tax Management Solutions

2.19 Tax Client Service Tools

Communications Tax: The Communications Tax toolkit includes: sales and delivery tools; marketing materials; client information; industry information; training information; information about communications solutions; contact information about federal, international, and state and local communications professionals; and a calendar of events.

Freedom of Information Act (FOIA): The Freedom of Information Act is a KPMG database of documents and forms detailing the process for filing requests for government documents under the Freedom of Information Act.

Global Tax Knowledgebase (GTK): The Global Tax Knowledgebase is a KPMG database of international tax strategies and global collaboration tool to advance ideas into marketable tax strategies. The Global Tax Knowledgebase allows professionals to

May 2002

search and browse for global tax strategies and collaboration tools to apply in engagements with clients throughout the world. After establishing an account accessible with a personalized user name and password, KPMG employees can search and browse through strategies, submit ideas, access the latest additions and research the GTK library. The toolkit is owned and maintained by the International Tax Center in Amsterdam.

International VAT Center (IVC): The International VAT Center helps clients navigate the complexities of the global tax arena and identify opportunities for indirect tax savings that impact the bottom line. IVC offers a wide variety of compliance and consulting services focused on helping business achieve tax efficiency country by country. Some IVC services include: reducing exposure to VAT, VAT planning, improving VAT cash flow, and helping clients to implement and maintain VAT software.

→ **KMatch:** KMatch is a tool to help tax professionals identify tax solutions and tax service ideas that may apply to a client.

KPMG/Elections: KPMG/Elections is a KPMG system for maintaining a list of a client's tax return elections and drafting tax return attachments.

Penalty Analyzer: Tax Controversy Services' Penalty Analyzer is a tool for determining whether the IRS has grounds for asserting the IRC Section 6662 penalty or whether the taxpayer has a basis for seeking abatement of a penalty assessment. The Penalty Analyzer toolkit also includes sample letters, definition and contact information.

make
browser?
cms used? → **Proposal Edge:** Proposal Edge is a proprietary, online system for developing proposals, presentations and other sales collateral. With regularly updated information, Proposal Edge provides a single repository for preapproved proposal content and brings speed and efficiency to proposal writing by simplifying the way information is gathered. Its step-by-step proposal building process helps to ensure that vital information is not overlooked and that the benefits of working with KPMG are clearly communicated. Proposal Edge can be a dramatic timesaving tool for KPMG professionals and staff.

RIA GoSystem: The RIA GoSystem reference page includes release news, user support, technology support, software tools, training resources and client usage information of the RIA software.

SALT Ideas by State: The SALT Ideas by State Web site is an extensive database of SALT solutions, ideas, potential planning opportunities, and certain exemptions and credits for all functional areas of SALT, all of which are organized in a map of the United States. The map allows professionals to "click" on a state and pull up those items relating to that particular state, organized by tax type or functional area.

SAT Toolkit: The Sales and Transactions Tax toolkit features SAT restructuring services, including LeaseCo, PromoCo and FinanceCo, plus such SAT controversy and consulting services as refund analysis, sales tax systems, simplified use tax reporting

environment and unclaimed property information. The Web site also features SAT discussion groups for collaboration, new SAT solutions and ideas, SAT technical materials by topic, key SAT technical resources, practice aides, people and training materials.

SBS Toolkit: The Strategic Business Solutions toolkit contains information on state tax planning strategies, a delivery model toolkit and training materials.

SRES Toolkit: The Strategic Relocation and Expansion Services toolkit includes: *Tax Solution Alerts*; hotlinks; SRES high-impact strategies; the BIG (Business Incentives Group) People database; completed engagement data; a delivery model toolkit; state tax summaries; and a link to the Global Location & Expansion Services Web site.

STRATIS Toolkit: As part of Personal Financial Planning services, the STRATIS program provides investment advice to KPMG clients. The STRATIS toolkit includes an overview of the program, marketing materials, client materials, training information, information about investment managers, manager profiles and registration information.

TaxScope: TaxScope is a global toolset for providing tax consulting services. TaxScope proves the framework for the consistent delivery of tax services worldwide. A Web-based portfolio of tools, TaxScope helps increase productivity on routine tasks and allows KPMG professionals to spend more time on value-added aspects of our work. With TaxScope, KPMG professionals can reduce duplication of effort, deliver seamless service to clients by utilizing a standard approach, increase revenue opportunities, improve collaboration among consulting teams and share knowledge and best practices globally.

Wealth Management Network (WMN): This toolkit provides information about the Wealth Management Network. WMN is an objective, personalized financial planning and investment advisory program to help manage wealth and secure financial future. The program utilizes STRATIS, Acumen and KPMG's Personal Financial Planning practice.

FFD
group?
marketing
taxes?

Web Writers' Page: The Web Writers' Page is for writers and editors in the U.S. tax practice who prepare content for the external Web site www.kpmgtax.com. The page includes instructions for creating and submitting content, reference tools and links, and a search of the articles and Webcasts posted on kpmgtax.com.

2.20 KPMG Firmwide Tax Training

- 2.20.1** Firmwide tax training is a component of the KPMG Center for Learning and Development. Tax training is aligned with the firmwide goals of retention and development. It is geared to support our overall tax strategy of driving tax solutions to the marketplace. KPMG tax leadership fully supports the concept of a shared commitment to training. The firm provides training opportunities with the expectation that our tax professionals will take full advantage of those opportunities to develop the skills needed to provide world-class service to our clients.

May 2002

2.21 National Marketing

- 2.21.1** National marketing is a shared service resident in Montvale, with professionals and resources dedicated to tax. The national tax marketing group has specific marketing resources assigned to support the national tax service lines. Additionally, there are professionals/resources available to assist in market planning and execution in each area, via area marketing directors (resident in the area headquarters with a team of professionals).

2.22 Human Resources

- 2.22.1** The KPMG tax human resources infrastructure consists of national and area Human Resource Business Consultants (HRBC) who support the human resource needs (e.g., employee relations, performance management, salary review, policy interpretation) of our national tax solutions groups, federal tax and federal tax solutions human resource needs. The HRBCs for the national tax solutions groups operate on a national basis and the HRBCs for the federal tax practices operate on a geographic basis. A list of our HRBCs is available on KWorld at <http://hrweb.us.kworld.kpmg.com/hrweb>.

2.23 Tax Recruiting

- 2.23.1** The KPMG experienced tax recruiting infrastructure consists of national and area recruiters who support our national tax practice needs. The recruiters for the national solutions groups operate and recruit for their business units on a national basis and the recruiters for the tax practice operate and recruit for their business units on a geographic basis. A current list of job postings and information about the various tax practices is available on the Careers@KPMG homepage at <http://hrweb.us.kworld.kpmg.com/hrweb/opp/index.asp>.

Part II—Practice Management

In this Part This part contains five chapters:

Chapter	Title
20	Tax Quality Performance Reviews
21	Professional Licenses
22	Conflicts of Interest
23	Speaking Engagements and Published Material
24	Tax Solution Development and Deployment

Chapter 20—Tax Quality Performance Reviews

20.1 Policy

The tax practice conducts annual Tax Quality Performance Reviews in accordance with KPMG International guidelines.

20.2 Objectives of Tax Quality Performance Reviews

20.2.1 The objectives of tax quality performance reviews are to evaluate and to contribute to improvement in:

- the effectiveness of the firm's quality control policies and procedures;
- the tax practice's compliance with those policies and procedures; and
- the level of performance of our tax professionals.

20.3 Responsibility for Tax Quality Performance Reviews

20.3.1 It is the responsibility of the Department of Professional Practice—Tax to administer and manage the Tax Quality Performance Review program.

20.3.2 It is the responsibility of the business unit professional practice partner—tax to coordinate with the Department of Professional Practice—Tax and the review teams to schedule and organize the interoffice reviews and to conduct the intraoffice reviews (i.e., self-reviews). The business unit professional practice partner—tax is also responsible for formulating and executing an action plan to address areas of weakness noted in the quality performance reviews.

20.4 Conducting Tax Quality Performance Reviews

20.4.1 The Tax Quality Performance Review program consists of annual interoffice and intraoffice reviews, and such reviews are conducted in accordance with the instructions developed and issued by the Department of Professional Practice—Tax.

20.4.2 Each office generally is selected for an interoffice review once in a three-year cycle; however, for larger offices, a portion of the office may be reviewed each year. A self-review is performed in those offices, and portions of larger offices, that were not included in the interoffice review for the particular year.

20.4.3 The firm's tax leadership nominates partners, tax managing directors and senior managers to be reviewers for interoffice reviews, and review teams are assigned by the Department of Professional Practice—Tax. Nominated partner and tax managing director reviewers generally serve until they complete three interoffice reviews, and senior manager reviewers serve until they complete two interoffice reviews. For intraoffice reviews, the business unit professional practice partner—tax is responsible for selecting reviewers and assigning review teams.

May 2002

- 20.4.4 At least two engagements for each partner and tax managing director and at least one engagement for each manager are selected for review as part of the annual Tax Quality Performance Review.
- 20.4.5 In addition to engagement reviews, a review of the location's internal controls is performed.
- 20.4.6 The combined results of the engagement reviews and internal controls review are evaluated to determine the office's overall compliance with general quality controls.
- 20.5 **Tax Quality Performance Review Results**
 - 20.5.1 The results of the tax quality performance reviews are reported, on an annual basis, to KPMG International, the firm's tax leadership and the vice chairman—assurance & advisory services.

Chapter 21—Professional Licenses

21.1	Policies
21.1.1	Overview
	Firm personnel refer to the AICPA's <i>Code of Professional Conduct</i> and comply with the Treasury Department Circular 230 rules governing the practice of attorneys, CPAs and enrolled agents before the Internal Revenue Service, as well as with rules of the various state boards of accountancy and licensing bodies.
21.1.2	Professional Licenses
	In the performance of their professional duties, firm professionals comply with applicable laws and regulations, including requirements that professionals performing certain services hold current licenses to practice. With limited exception, firm personnel who are not licensed CPAs, licensed attorneys or enrolled agents do not practice before the Internal Revenue Service.
21.1.3	Holding Out as a CPA
	Signing a power of attorney or extension request, or otherwise representing a client before the IRS, in one's capacity as a CPA, can be construed as holding oneself out as a CPA under a state's accountancy rules. Accordingly, as a general matter, all KPMG tax personnel who are CPAs hold a valid CPA license issued by the state of their principal office.
	In all cases, KPMG tax <i>partners</i> hold valid CPA licenses issued by the state of their principal office.
21.1.4	Holding Out as an Attorney
	Firm personnel exercise caution in their professional conduct to protect the firm from allegations of the unauthorized practice of law and consult with the Office of General Counsel in appropriate circumstances.
21.1.5	Representation Before State or Local Tax Authorities
	Firm professionals may represent clients before state taxing authorities or state or local administrative bodies or tribunals where the rules of the forum so provide and the professional meets the licensing requirements of the forum. Where the client is an audit client that is an SEC registrant, the representation is further limited to instances where: (a) it is common for non-lawyers to represent clients in the forum; and (b) the matter is not expected to be publicized in nontax publications.

May 2002

21.2 Code of Conduct

- 21.2.1** The established rules and regulations of the American Institute of Certified Public Accountants' (AICPA) *Code of Professional Conduct*, the ethical standards of state CPA societies and boards of accountancy, and other applicable laws and regulations guide us in the performance of our duties and the firm's acceptance of responsibility for services provided to clients.
- 21.2.2** Firm personnel also comply with Treasury Department Circular 230 rules governing the practice of attorneys, CPAs and enrolled agents before the IRS.
- 21.2.3** For further discussion of professional standards, refer to Chapter 10 of the *RMM—U.S.*

21.3 Professional Licenses

- 21.3.1** In the performance of their professional duties, firm professionals comply with applicable laws and regulations, including requirements that professionals performing certain services hold current licenses to practice.

21.4 Representation Before the Internal Revenue Service**21.4.1** Firm personnel who

- obtain authority to represent a client under a power of attorney,
- sign an extension request on behalf of a client, or
- otherwise represent they are authorized to practice before the IRS

are (1) licensed CPAs, (2) licensed attorneys or (3) enrolled agents.

- 21.4.2** With limited exceptions, firm personnel who are not licensed CPAs, licensed attorneys or enrolled agents **do not** practice before the Internal Revenue Service.

21.5 Definitions of Terms

Licensed CPA: Any person who holds a Certified Public Accountant (CPA) certificate and an **active** license or permit to practice as a certified public accountant in any State, possession, territory, Commonwealth or the District of Columbia.

Licensed attorney: Any person who is an **active** member in good standing of the bar of the highest court of any State, possession, territory, Commonwealth or the District of Columbia.

Enrolled agent: Any person enrolled as an agent pursuant to Treasury Department Circular 230.

Practice before the Internal Revenue Service: Includes all matters connected with presentation to the IRS relating to a client's rights, privileges or liabilities under laws or

regulations administered by the IRS. Such presentations include the preparation and filing of necessary documents, correspondence with and communications to the IRS and the representation of a client at conferences, hearing and meetings.

21.6 Holding Out as a CPA

- 21.6.1** Most states define the practice of public accounting to include the performance of tax services by a person holding himself or herself out to the public as a licensed CPA. Further, most states generally require an individual practicing public accountancy within a state to hold a license to practice as a CPA issued by that state.
 - 21.6.2** Signing a power of attorney or extension request, or otherwise representing a client before the IRS, in one's capacity as a CPA, can be construed as holding oneself out as a CPA under a state's accountancy rules. Accordingly, as a general matter, all KPMG tax personnel who are CPAs hold a valid CPA license issued by the state of their principal office. Where a KPMG tax person holds a CPA certificate from a state or states other than the state of his or her principal office, but does not hold a valid CPA license from the latter state, steps are to be taken to obtain that license as soon as practicable. If it is not feasible to obtain a CPA certificate from the state of one's principal office due to the particular licensing requirements of that state, the business unit professional practice partner—tax and the area risk management partner may grant the individual an exemption from obtaining a CPA license in that state.
 - 21.6.3** In all cases, KPMG tax *partners* hold valid CPA licenses issued by the state of their principal office. In each case where a tax partner does not have a current CPA license issued by the state of his or her principal office, he or she should not be listed as a CPA in the phone book or in any other state or local directories. The title "partner" should not appear on his or her business cards and should not be used on correspondence, nor should a certificate evidencing his or her CPA designation be publicly displayed within the state. If he or she will be representing a client before the Internal Revenue Service in the state of his or her principal office, the partner in charge of the Department of Professional Practice—Tax is to be consulted as to the appropriate means of accomplishing the representation. The individual is to take all practical steps to meet the licensing requirement in the state of his or her principal office and to obtain a CPA license from that state.
- ## **21.7 Holding Out as an Attorney**
- 21.7.1** Firm personnel exercise caution in their professional conduct to protect the firm from allegations of the unauthorized practice of law and consult with the Office of General Counsel in appropriate circumstances. For a further discussion of this and other legal matters, refer to Chapter 31 of the *RMM—U.S.*
 - 21.7.2** The listing of law degrees in referring to the educational background of firm professionals and the disclosure of membership in a bar association, such as the American Bar Association, are permitted in biographical summaries; however, the designation *member of the bar* may not be listed.


May 2002

- 21.7.3** Firm personnel who are attorneys may be members of the American Bar Association, state bar associations or local bar associations, but are not listed in *Martindale-Hubbell Law Directory* or other lawyer reference directories. Reimbursement of bar association dues is at the discretion of the business unit tax partner in charge or the area partner in charge of the appropriate tax service group.

21.8 Representation Before State or Local Tax Authorities

- 21.8.1** In addition to representing clients before state taxing authorities, firm professionals may represent clients in state and local administrative bodies and tribunals. Firm professionals may represent clients in such forums where the rules of the forum so provide and the professionals meet the licensing requirements of such forum. Where the client is an audit client that is an SEC registrant, firm professionals are further cautioned that their representation is limited to instances where: (a) it is common for non-lawyers to represent clients in the forum; and (b) the matter is not expected to be publicized in nontax publications.

Chapter 22—Conflicts of Interest

22.1	Policies
22.1.1	Conflicts of Interest in Tax Matters
	Firm professionals remain alert to potential conflict situations, including situations that have the appearance of a conflict, and resolve them in a manner that is consistent with firm and professional standards. Firm tax personnel should contact their business unit professional practice partner—tax for guidance on how to proceed in a particular factual setting.
	22.1.2
	Performance of Services With Objectivity
	If we determine that there may be a conflict of interest in the performance of services for a client or prospective client, we do not enter into or continue the engagement unless we independently determine that we are able to perform the services with <u>objectivity and integrity</u> .
	22.1.3
	Disclosure and Consent to Conflict
	If we learn of a conflict of interest in one or more engagements, we may not be able to proceed unless the conflict is disclosed to, and consent is obtained from, the affected party or parties.
	22.1.4
	Conflicts Involving Government Employees
	Former government employees who join KPMG should promptly contact a member of the Department of Professional Practice—Tax for a <i>conflicts briefing</i> .
22.2	Conflicts of Interest in Tax Matters
22.2.1	Firm professionals remain alert to potential conflict situations, including situations that have the appearance of a conflict, and resolve them in a manner that is consistent with firm and professional standards. According to AICPA Interpretation 102-2, “A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member’s professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member’s objectivity.” AICPA Interpretation 102-2 includes various examples of potential conflict situations.
22.2.2	Firm tax personnel should contact their business unit professional practice partner—tax for guidance on how to proceed in a particular factual setting. In some cases, we may have to decline or withdraw from one or more engagements. Where a conflict situation involves a couple who are separated, divorcing or divorced, firm personnel are to consult with the business unit professional practice partner—tax, who in turn may

May 2002

consult with the Office of General Counsel, prior to agreeing to be engaged by both husband and wife.

- 22.2.3** There are other situations in which our actions could conflict with the interests of a client or prospective client (such as writing an article advocating a particular interpretation of the tax law or a judicial decision). Firm professionals also should exercise discretion in these “business conflict” situations, acting in a manner that is consistent with our responsibilities to our clients and the firm.

22.3 Performance of Services With Objectivity

- 22.3.1** If we determine that there may be a conflict of interest in the performance of services for a client or prospective client, we do not enter into or continue the engagement unless we independently determine that we are able to perform the services with objectivity and integrity.

22.4 Disclosure and Consent to Conflict

- 22.4.1** If we learn of a conflict of interest in one or more engagements, we may not be able to proceed unless the conflict is disclosed to, and consent is obtained from, the affected party or parties. The form of disclosure and consent may vary with the particular factual setting. If possible, it generally is preferable to obtain the consent of the affected party or parties by having the party or parties execute a written conflict waiver. Model waivers are on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>. If an affected party has not yet engaged us, the consent to the conflict also should be referenced in the engagement letter. If we do not obtain consent to the conflict, the appropriate course is a matter of professional judgment and may include declining or withdrawing from one or more of the engagements.

22.5 Conflicts Involving Government Employees

- 22.5.1** Conflict of interest problems may arise in the recruiting of government employees and in the involvement of former government employees in client or firm matters after the former employee joins KPMG. Specific guidance on conflicts for employees (or former employees) of the executive branch of the U.S. government can be found in 18 U.S.C. Section 207 and Section 208 and, in the case of employees (or former employees) of the U.S. Treasury Department (including the IRS), in Section 10.26 of Treasury Department Circular 230. Under certain circumstances, Treasury Department Circular 230 requires a former government employee to be screened from participation in a matter and to file an isolation statement with the IRS. Treasury Department Circular 230 may be accessed through the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 22.5.2** Former government employees who join KPMG should promptly contact a member of the Department of Professional Practice—Tax for a *conflicts briefing*. This briefing is to help familiarize the new hire with potentially relevant post-employment conflict rules, alert the new hire to potential conflicts and determine the matters, if any, from which the employee is required to be isolated.

Chapter 23—Speaking Engagements and Published Material

23.1 Policies

23.1.1 Speaking Engagements

Tax services personnel who accept an out-of-town speaking engagement are requested to notify the business unit partner in charge—tax for the location where the speech will be delivered so that the partner may consider whether to have local firm representatives attend the event. Speech outlines are submitted to the Outlook address, Tax Knowledge Inbox, using a TKS submission template no later than one week after the speech is given.

23.1.2 Published Material

Tax personnel follow the firm's procedures for technical and policy review of tax-related materials distributed to persons outside the firm *prior to publication or distribution*.

23.1.3 Brand and Regulatory Guidelines

Firm professionals are to adhere to the *KPMG Brand and Regulatory Compliance Guidelines* when preparing electronic and print versions of internal and external communications. If more than 30 percent of the intended audience is outside the United States, then firm professionals also adhere to the *KPMG International Brand and Regulatory Compliance Guidelines*.

23.2 Speaking Engagements

23.2.1 The firm encourages tax services personnel to speak at tax-related programs and seminars.

23.2.2 Most speaking engagements present practice development opportunities, if the speaker and other firm professionals who attend learn as much as possible about the audience ahead of time and then follow up individually with high-potential attendees at the event.

23.2.3 Tax services personnel who accept an out-of-town speaking engagement are requested to notify the business unit partner in charge—tax for the location where the speech will be delivered so that the partner may consider whether to have local firm representatives attend the event.

23.2.4 The tax professional is to obtain consent from his or her practice leader prior to accepting the speaking engagement.

May 2002

23.3 Speech Outlines

- 23.3.1 Speech outlines and other speech presentation materials are to be technically reviewed in accordance with the review requirements outlined in Chapter 41 of this manual.
- 23.3.2 Speech outlines and other speech presentation materials are submitted to the Outlook address, Tax Knowledge Inbox, using a TKS submission template no later than one week after the speech is given.

23.4 Published Material

- 23.4.1 Tax personnel follow the firm's procedures for technical and policy review of tax-related materials distributed to persons outside the firm *prior to publication or distribution*. These procedures are set forth in the technical and policy review chart in paragraph 23.6.1 below.
- 23.4.2 As noted in the technical and policy review chart, broadly distributed mailings, such as newsletters, booklets and brochures, are to include the following or substantially similar precautionary language:

The information contained herein [or insert name of the publication, newsletter or other mailing] is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor.

- 23.4.3 When writing articles for publication, firm personnel avoid discussing actual situations that may be identified with a client, unless client approval is obtained in writing prior to publication of the article.

23.5 Brand and Regulatory Guidelines

- 23.5.1 Firm professionals adhere to the *KPMG Brand and Regulatory Compliance Guidelines* when preparing electronic and print versions of internal and external communications. This publication contains guidelines and policies for protecting the KPMG brand and brand image, as well as, the reputation of KPMG.
- 23.5.2 *KPMG International Brand and Regulatory Compliance Guidelines* is the only internationally approved guidance on the KPMG brand and related risk management issues. It applies to all parts of the KPMG organization, including KPMG International and KPMG member firms. If more than 30 percent of the intended audience is outside the United States, then firm professionals also adhere to the *KPMG International Brand and Regulatory Compliance Guidelines*.

23.6 Technical and Policy Review Chart for Published Material

23.6.1 This chart summarizes the requirements for review of tax-related materials and information that are distributed, delivered or otherwise made available (e.g., through posting on the Web) to be persons outside the firm. Note that, except for speeches, all review requirements are to be satisfied *before* the materials are distributed, delivered or otherwise made available outside the firm.

Tax Materials	Originating Location Technical Review (1)	DPP—Tax Policy Review	Washington National Tax Technical Review (2) (3)	Brand & Regulatory Compliance Review (6)
Advertisements		X		X
Articles and books	X	X	X	
Booklets/brochures (5)	X	X	X	X
Invitations		X		X
Legislative/regulatory comments	X	X	X(8)	
Letters (7)	X	X		
Newsletters (5)	X	X	X	X
Press releases		X		X
Speeches	X	X(4)		
Videos		X	X	X
Web site content	X	X	X	X

- (1) Review, including verification of citations, is performed by a tax services partner, principal or manager other than the preparer. If the reviewer is a manager, the material is to be approved for issuance by a tax services partner or principal.
- (2) Washington National Tax may defer to the appropriate technical tax resource.
- (3) For comments pertaining to multistate matters, WNT-SALT performs the technical review, but for comments pertaining to a particular state, a member of the State Resource Network for that state performs the technical review. The State Resource Network can be found on the SALT homepage at <http://taxkm.us.kworld.kpmg.com/homepages/salt/index.htm>.
- (4) Speech outlines are sent to the Outlook address, Tax Knowledge Inbox, from where they are forwarded to the Department of Professional Practice—Tax within one week after delivery for policy review and possible inclusion in the firmwide speech database.
- (5) Broadly distributed mailings, such as newsletters, booklets and brochures, are required to include precautionary language. See paragraph 23.4.2 of this manual for further details.
- (6) Note that Brand & Regulatory Compliance (B&RC) reviews laid-out materials only (i.e., the final version that will be sent to the printer). For additional information, please refer to the B&RC Guidelines at <http://kworld.kpmg.com/microwebs/us/marketing/brcguidelines/index.html>.
- (7) Applies to mailings of standard letters to a group of existing and/or prospective clients (e.g., letters describing new ideas or services).
- (8) Additional approval requirements for tax legislative activities (including commentary on proposed regulations) are set forth in Chapter 64 of this manual.

Chapter 24—Tax Solution Development and Deployment

24.1 Policies

24.1.1 General

Appropriate technical, risk management, and other firm resources are applied to the development and deployment of a tax solution. For purposes of this chapter, a *tax solution* is a tax planning idea, structure, or service that potentially is applicable to more than one client situation and that is reasonable to believe will be the subject of leveraged deployment. No minimum revenue threshold applies for defining what is a *solution*.

In general, a solution is not deployed until development of the solution is complete. Development of a solution is not complete until the solution has the requisite sign-offs by the appropriate technical, risk management, and any other personnel.

Approval of a new tax solution by the partner in charge of the Department of Professional Practice—Tax may include conditions on the manner in which the solution is marketed or delivered and on language to be included in engagement letters or other communications with clients, prospective clients and third parties.

For additional information on the WNT solutions development process, refer to the WNT Solution Owners Web page at <http://taxkm.us.kworld.kpmg.com/homepages/wnt/wntonline/solutions/index.htm>.

24.1.2 Specific Service Groups

Additional professional practice policies are provided for the development and deployment of tax strategies and opportunities in the following service groups: State and Local Tax (SALT) and Strategic Business Solutions (SBS).

24.2 General

24.2.1 Appropriate technical, risk management, and other firm resources are applied to the development and deployment of a tax solution. For purposes of this chapter, a *tax solution* is a tax planning idea, structure, or service that potentially is applicable to more than one client situation and that is reasonable to believe will be the subject of leveraged deployment. No minimum revenue threshold applies for defining what is a *solution*.

24.3 Submitting and Approving Ideas for Development

24.3.1 Ordinarily, the development of a solution commences with the submission by a tax leader of an idea to Washington National Tax (WNT) on a Solutions Submission Form. A tax leader is a tax partner, principal, non-partner functional/service line leader, or tax

Beta
Tests

May 2002

managing director. Other firm professionals wishing to submit solution ideas to WNT should involve a tax leader in the process.

- 24.3.2** The leader of the WNT functional group with the primary responsibility for the issues presented by the solution approves (or disapproves) development of the idea. If development is approved, the WNT functional group leader appoints a WNT solution owner, a WNT lead development partner (who may also serve as the WNT solution owner), and a WNT secondary approval partner. The WNT functional group leader informs these people of their roles and directs the WNT solution owner to move forward with the development process. The *WNT solution owner* is a manager or partner in the functional group with the primary responsibility for the issues presented by the solution. The WNT solution owner “owns” the responsibility of getting the idea through development in WNT.

Developing Solutions

24.4 WNT Technical Review Activities

- 24.4.1** Once a solution is approved for development, the WNT solution owner makes any modifications to the Solution Submission Form information that are appropriate at that time and resubmits the form. At this point, the Solution Submission Form information and attachments are also sent to the Department of Professional Practice—Tax (to address risk management issues) and the WNT Tax Controversy Services group (to address tax shelter regulations issues). This early notification of the Department of Professional Practice—Tax and the WNT Tax Controversy Services group allows these groups to conduct their work on the solution at the same time WNT is conducting its technical development of the solution.
- 24.4.2** In developing the solution, the documents to be prepared by the WNT development team and delivered upon completion of technical review are (1) a Solution Abstract and (2) a standard engagement letter. In some cases it may also be appropriate for WNT to prepare standard client presentations. The Solution Abstract may be a *Microsoft Word™* or *PowerPoint™* file, containing a description of (a) the scope of KPMG services to be provided clients in delivering the solution, (b) a prototypical fact pattern, (c) the transaction steps, (d) the intended tax consequences, (e) a description of technical underpinnings of the strategy, likely challenges to the technical conclusions, and the manner in which those challenges will be overcome (including citations), and (f) any diagrams that facilitate understanding or marketing of the transaction.

24.5 Approvals

- 24.5.1** **Technical sign-off.** WNT development of the solution is complete when the WNT lead development partner and WNT secondary approval partner give technical sign-off on the Solution Abstract. The WNT lead development partner is responsible for securing the sign-off of the WNT secondary approval partner. Before providing technical sign-off, the WNT lead development partner secures the approval of a partner in any other WNT functional group(s) involved in development. The WNT secondary approval partner is responsible for reviewing the technical conclusions made by the WNT lead development partner.

Once technical sign-off occurs, the WNT solution owner submits the Web-based WNT Solution Completion Form, marking the box indicating "Technical Review - Approved for Deployment." The Department of Professional Practice—Tax and the WNT Tax Controversy Services group are also sent a similar Web-based form that requests their review completion.

- 24.5.2 DPP—Tax sign-off.** The partner in charge of the Department of Professional Practice—Tax must approve all solutions from a risk management perspective before they are deployed. The partner in charge of the Department of Professional Practice—Tax also consults with, and obtains the approval of, the Department of Professional Practice—Assurance on GAAP and independence issues.

In general, the WNT solution owner obtains all necessary technical approvals of a solution and major deliverables before submitting them to the Department of Professional Practice—Tax for its final approval. If a solution may raise significant professional practice or risk management issues, it is advisable to consult with the Department of Professional Practice—Tax early in the development process for its views on those issues.

The partner in charge of the Department of Professional Practice—Tax generally will not approve a solution unless the appropriate WNT partner(s)/principals(s) conclude that it is at least more likely than not that the desired tax consequences of the solution will be upheld if challenged by the appropriate taxing authority (e.g., the IRS). In the event that the Department of Professional Practice—Tax does not approve a solution, the originator(s) may revise the solution to make changes designed to meet express objections of the partner in charge of the Department of Professional Practice—Tax and resubmit the revised solution or for approval.

- 24.5.3 WNT Tax Controversy Services sign-off.** The WNT lead development partner specifies the WNT functional group responsible for analyzing the solution under the tax shelter regulations and ensures that this analysis is submitted to the WNT Tax Controversy Services group for that group's review and sign-off.
- 24.5.4 Tax Innovation Center sign-off.** If the solution is to be reflected in a *Tax Solutions Alert* or *Tax Services Idea*, or widely communicated to one or more segments of the tax practice by conference call, the solution and major deliverables items also are approved in writing by the Tax Innovation Center (TIC) leadership team partner.
- 24.5.5 Member firm sign-off.** If a solution involves both foreign and U.S. tax planning, technical and risk management review and approval of the foreign tax aspects of the solution also are obtained from the appropriate technical resource(s) in the member firm in the applicable foreign jurisdiction.

For additional information on the WNT solutions development process, refer to the WNT Solutions Owners Web page at <http://taxkm.us.kworld.kpmg.com/homepages/wnt/wntonline/solutions/index.htm>.

May 2002

24.6 Deploying Solutions

24.6.1 WNT Involvement. It will often be the case that the success of deployment activities is enhanced if WNT continues to be involved in the deployment of the solution to individual client situations. Continued WNT involvement is particularly necessary in the case of solutions for which only limited development and deployment materials may have been made available.

24.6.2 Opinions requiring special approvals. In addition, if in the course of the deployment of a solution, it becomes apparent that an opinion will be issued for which WNT and/or Department of Professional Practice—Tax review is required or will be requested, the procedures for such opinion approvals should be followed. See Chapter 41 for guidance on opinion approval requirements.

24.6.3 Conditions on marketing. Approval of a new tax solution by the partner in charge of the Department of Professional Practice—Tax may include conditions on the manner in which the solution is marketed or delivered and on language to be included in engagement letters or other communications with clients, prospective clients and third parties.

Once a particular solution has been approved, it may be marketed by multiple KPMG personnel to multiple potential clients, subject to the conditions set forth below.

- The *Tax Solution Alert* or other document announcing the solution may restrict the marketing or delivery of the solution to designated KPMG personnel; and
- The partner in charge of the Department of Professional Practice—Tax may determine at any time that KPMG personnel are to cease marketing a previously approved solution due to changes in circumstances, law, regulations or other administrative pronouncements, or market conditions. In the event of such a decision, the owner of the solution and the partner in charge of the Department of Professional Practice—Tax will confer as to the appropriate disposition of situations where the solution has been marketed to a potential client but the project has not yet commenced.

24.6.4 Accounting matters. If the client is a KPMG audit client, tax professionals should consult with the audit team to determine the financial statement implications of the solution. In addition, the solution may impact the recognition of current and deferred taxes for financial statement purposes. Where the client is not a KPMG audit client, the tax engagement team must advise the client to consult with its own auditors concerning the financial statement implications of the solution. See Chapter 44 for additional guidance on accounting advice.

State and Local Tax (SALT) Services**24.7 Area or Locality Specific**

24.7.1 The State and Local Tax (SALT) practice, unlike many other service groups, deals with over 50 state and local taxing jurisdictions and multiple types of taxes. Therefore,

certain strategies and opportunities (i.e., claims for refund) offered to clients may not be appropriate for solution development by Washington National Tax and the Department of Professional Practice—Tax.

- 24.7.2** Any SALT idea that is based on a prospective filing position or a new service is subject to the process contained in sections 24.2 through 24.6 of this chapter, regardless of its area or locality specificity.
- 24.7.3** An idea satisfying all of the following criteria does not need to be submitted to WNT for solution development or approval:
- a state-specific strategy or opportunity;
 - that will not be marketed on a national basis, at least initially; and
 - that is “low risk” (e.g., a stand-alone refund opportunity is usually “low risk”).
- 24.7.4** The following review and approval procedures are followed for SALT strategies or opportunities that are area or locality specific:
- prior to offering the idea to a client or prospect, the idea is reviewed and approved by the State Resource Network member for the specific state and specific SALT functional tax area (e.g., income/franchise tax);
 - prior to offering the idea to a client or prospect, the idea is reviewed and approved by a SALT partner and the functional area practice leader for the geographic area to which the idea applies (if the functional area practice leader is also a partner, a separate partner sign-off is not required); and
 - the reviews and approvals are documented, and a copy of the documentation and technical memoranda in support of the idea are sent to the professional practice partner—tax for the business unit.

24.8 Strategic Business Solutions

- 24.8.1** Strategic Business Solutions (SBS) is a multi-phased, solutions-based, results-oriented service that focuses on the single state or multistate reduction of one or more taxes by restructuring a client’s corporate entity structure and redefining the relationships among those entities. An SBS may result in effective state tax rate reductions and can also produce financial statement benefits. Although occasionally combined, the four phases of an SBS engagement are: feasibility, design, implementation, and post-implementation. For some engagements, the client may prefer that design and implementation be combined and post-implementation review may not be part of the SBS engagement.
- 24.8.2** During the feasibility phase, state tax savings opportunities are identified and the merits of pursuing the opportunities are assessed. Usually, the feasibility phase includes an initial on-site review of a company’s organizational structure, operations, and prior state tax filings. Once the feasibility analysis is completed, the discrete strategies that

May 2002

will form the basis of the SBS plan are presented together with the potential state tax savings associated with those strategies. The deliverables associated with feasibility are the “Feasibility Progress Report,” a detailed presentation of the feasibility strategies and projected savings benefits that is usually made to the client’s tax department, and the “Feasibility Presentation,” which is provided to the client’s *buyer* (i.e., CEO or CFO and other high-level client officers). Prior to the Feasibility Presentation, the Feasibility Progress Report is reviewed by a SALT partner unrelated to the engagement.

As part of the feasibility process, KPMG M&A Operations should be consulted for assistance and review of the potential, feasible SBS structure to identify potential federal issues that could be implicated and to suggest potential solutions to those issues.

- 24.8.3** Design is an iterative process involving the collaborative efforts of the KPMG and client teams. In the design phase, the strategies proposed in feasibility are evaluated and refined; ancillary costs are assessed; applicable tax laws, as well as regulatory and operational issues, are evaluated; and design conclusions are documented through a series of interim design reports and periodic status meetings. At the conclusion of the design phase, the client is presented with a Final Design Report or, in lieu thereof, a collection of technical memoranda documenting the design of the SBS structure. Prior to providing the Final Design Report (or collection of technical memoranda) to the client, two reviews take place. First, the Final Design Report and supporting technical memoranda (or only the collection of technical memoranda if a Final Design Report is not to be provided to the client) are reviewed by a SALT partner unrelated to the engagement. This review provides an independent evaluation of the soundness of the overall strategy. Second, the Final Design Report and supporting technical memoranda (or only the collection of technical memoranda if a Final Design Report is not to be provided to the client) are reviewed by the appropriate national technical resource, usually in Washington National Tax (e.g., Subchapter C group, Subchapter K group, international tax group). This review determines that the national and international tax ramifications of the design documentation are examined and evaluated. When the final design of the SBS structure is agreed to and approved by the client, KPMG prepares an implementation work plan for client review and approval. This work plan details all actions that are to take place during implementation and will assign responsibilities and completion dates.

As part of the design process, KPMG M&A Operations professionals are to be consulted for assistance with and review of the final design of the SBS structure to identify potential federal issues that could be implicated and to suggest potential solutions to those issues.

- 24.8.4** The implementation phase involves the execution of the specific action steps outlined in the implementation work plan, as well as other actions necessary to resolve tax and non-tax issues associated with the SBS. In addition to completing the action steps detailed in the work plan, implementation includes providing tax-related advice to legal counsel that is necessary with respect to the drafting of legal documents and agreements by legal counsel.

- 24.8.5** Finally, within 12 months after implementation, KPMG and the client may mutually agree on an acceptable period within which to perform post-implementation review. If the client agrees to engage KPMG for post-implementation review, KPMG works with the client to determine whether the SBS strategies are operating in an appropriate manner in light of any significant business or structural changes communicated to KPMG.
- 24.8.6** It is strongly encouraged that design reports are not to be provided to the client. Instead, a collection of technical memoranda that thoroughly address the federal, state, and other tax consequences of the SBS structure should be provided to the client as they are completed. The following guidelines are to be followed when preparing design deliverables:
- memos do not address non-tax (i.e., operational tax, legal, accounting) considerations. Only tax technical analysis of implementing a particular or structure are provided;
 - refer to the guidance provided under SAS 50 when the accounting treatment of a transaction is desired;
 - each memo has a standard facts session, along with additional facts pertinent to the issue at hand; and
 - clients document the business purpose behind a particular transaction or structure and the memo is communicated to KPMG.
- 24.8.7** All proposed final design documentation (whether titled “Final Design Report” or the collection of technical memoranda) is reviewed and approved by the appropriate national technical resource in WNT (e.g., subchapter C, consolidated returns, subchapter K, compensation and benefits) and by a SALT partner unrelated to the engagement prior to issuance. In addition, for engagements where the fee is in excess of \$1 million, WNT-SALT review is required. This review will also serve as the independent SALT partner review and WNT-SALT will coordinate all other necessary technical resource reviews. A summary of all SALT review procedures is contained in the Professional Practice Update, which is periodically updated and posted to the SALT homepage at <http://taxkm.us.kworld.kpmg.com/homepages/salt/index.htm>.

Part III—Tax Engagement Procedures

In this Part This part contains eight chapters:

Chapter	Title
30	Client Evaluations and Terminations
31	Tax Engagement Letters
32	Fee Arrangements
33	Tax Engagement Responsibilities and Files
34	Large Case Project Management
35	Confidentiality, Exclusivity and Privacy
36	Engagement Information Form
37	Foreign Tax Advice and Multi-firm Engagements

Chapter 30—Client Evaluations and Terminations

30.1 Policies

30.1.1 Prospective Client Evaluations and Annual Client Risk Assessments

Before accepting an engagement for a new client, we complete an evaluation of the prospective client. Clients are reviewed annually by the engagement partner to determine whether a formal reevaluation is necessary.

30.1.2 Tax Services Provided to Other Tax Advisors

Certain procedures are followed when KPMG is requested to render tax advice to another tax advisor for the advisor's use. The procedures vary depending on whether KPMG's advice or involvement will be disclosed to the other tax advisor's client.

30.1.3 Client Relationship Terminations

When KPMG terminates a client relationship or when a client voluntarily terminates its relationship with KPMG, the decision is discussed with the client in person or via the telephone. In either situation, in order to provide for a clear understanding as to the future responsibilities of both KPMG and the terminated client, it is recommended that the engagement partner or tax managing director promptly follow up with a letter to the former client confirming the termination of the client relationship in writing.

30.2 Prospective Client Evaluations and Annual Client Risk Assessments

30.2.1 Before accepting an engagement for a new client, an evaluation of the prospective client is performed. The evaluation process is completed prior to the commencement of fieldwork, even if the engagement is in *feasibility* or otherwise may not generate fees. Client acceptance, continuance and approval requirements apply to all services. For tax-only new clients, a form WP-220 is completed and approved by the evaluating partner or tax managing director and the professional practice partner—tax for the business unit where the lead tax engagement partner is located. When the evaluating partner is the professional practice partner—tax for the business unit, the professional practice partner of an adjacent business unit provides the approval. Prospective client evaluation forms are located on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

30.2.2 With respect to potential engagements with a new client that is a client of another KPMG member firm, due consideration is given to the prospective client's association with that member firm, and we exercise appropriate diligence in determining whether to accept a client of the KPMG member firm or an engagement with such client. Further guidance on multi-firm engagements is set forth in Chapter 37 of this manual.

30.2.3 In those situations where we will be providing services directly to a new client that is referred by another KPMG member firm, the new client is subject to the prospective


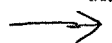
May 2002

client evaluation process, even if the client or its parent is an existing client of the KPMG member firm.

- 30.2.4** All tax clients are reviewed annually by the engagement partner to determine whether a formal reevaluation is necessary. The business unit professional practice partner—tax oversees the annual risk assessment of existing tax clients and reviews the evaluations with each tax engagement partner.
- 30.2.5** Additional policy and guidance concerning client evaluations is set forth in Chapter 20 of the *RMM—U.S.*

Tax Services Provided to Other Tax Advisors

30.3 General

-  **30.3.1** Occasionally, other tax advisors may not have the appropriate technical expertise to competently address certain tax issues that may affect their clients. These other tax advisors, usually small to midsize CPA or law firms, may approach KPMG to consult on these matters. The guidance below applies irrespective of whether the other advisor is a former partner or employee of KPMG.
-  **30.3.2** Refer to Chapter 61 (which addresses the attorney-client and other privileges) of this manual for guidance when we are engaged by a law firm under a “Kovel” agreement to assist the law firm in providing legal advice to its client.

30.4 Other Tax Advisor Is the Client

- 30.4.1** If KPMG is requested to render tax advice to another tax advisor for the advisor’s use in evaluating its advice to its clients **and** KPMG’s involvement **will not be disclosed** to the other tax advisor’s clients, the following procedures apply:
- a prospective client evaluation for the other tax advisor is performed;
 - a signed engagement letter that includes KPMG’s Standard Terms and Conditions—Tax Engagements is obtained from the other tax advisor; and
 - the engagement letter includes a paragraph stating that our advice is being rendered directly to the other tax advisor for its use in evaluating its advice to its clients. The other tax advisor shall not represent to its clients that KPMG has provided the tax advice.
- 30.4.2** A sample engagement letter is available on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

30.5 Other Tax Advisor’s Client Treated as KPMG Client

- 30.5.1** If KPMG is requested to render tax advice about specific client matters and that advice **or** KPMG’s involvement will be made known to the other tax advisor’s client, the following standard client procedures apply:

- a prospective client evaluation is performed for each client of the other tax advisor to whom KPMG's advice is given, and if the other tax advisor will be paying KPMG's fees, a prospective client evaluation also is performed for the other tax advisor;
- an engagement letter that includes KPMG's Standard Terms and Conditions—Tax Engagements is signed by the client of the other tax advisor; and
- the engagement letter stipulates the party or parties responsible for KPMG's fees. If KPMG arranges to bill the other tax advisor for the services rendered, an additional engagement letter that includes KPMG's Standard Terms and Conditions—Tax Engagements and that sets forth KPMG's fee arrangement is obtained from the other tax advisor.

30.6 Client Relationship Terminations

- 30.6.1** Usually, when KPMG terminates a client relationship, the decision is discussed with the client in person or via the telephone. Similarly, when a client voluntarily terminates its relationship with KPMG, the termination usually is discussed with the engagement partner or done via letter.
- 30.6.2** In either situation, in order to provide for a clear understanding as to the future responsibilities of both KPMG and the terminated client, it is recommended that the engagement partner or tax managing director promptly follow up with a letter to the former client confirming the termination of the client relationship in writing. The letter indicates the last date that KPMG will provide services to the client, the years and returns of the last compliance work that the firm will be responsible for, as well as the status and expected completion date of any tax consulting projects in progress. A sample termination letter can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 30.6.3** The conditions of access by the terminated client to our work papers and electronic files (e.g., GoRS locators) are to be determined on a case-by-case basis. As a general rule, any such access is not granted unless all our professional fees have been paid. Chapter 50 of this manual sets forth policies and provides guidance with respect to third-party access to tax-related material.
- 30.6.4** The letter also notifies the client of any unpaid fees, including unbilled time. It is preferable that a final billing with all time captured through the date of termination be sent along with the termination letter. Such a communication helps reduce misunderstandings as to future responsibilities. Additional guidance regarding unpaid fees is set forth in section 32.13 of this manual.
- 30.6.5** Where both assurance and tax services to a client are being terminated, the tax engagement partner discusses with the assurance engagement partner whether a combined assurance and tax client relationship termination letter is appropriate.

Chapter 31—Tax Engagement Letters

31.1 Policies

31.1.1 Engagement Letters

Other than for certain individual tax return engagements, we issue and receive signed engagement letters for all tax engagements. The engagement letter should set forth a description of the services to be provided and the fee arrangements for those services, and should state that the attached Standard Terms and Conditions are made a part of the engagement letter.

31.1.2 Standard Terms and Conditions

The professional practice partner—tax for the business unit where the lead tax engagement partner is located approves any modifications to the Standard Terms and Conditions. Such modifications are noted in the body of the engagement letter.

31.1.3 Engagement Letter Approval

In some cases, an engagement letter may not be issued to the client until it is approved by either the Department of Professional Practice—Tax or the business unit professional practice partner—tax.

31.1.4 Engagement Billing

If services billed to a business entity encompass services provided to an individual, the scope of services provided to the individual and the amount of fees for such services are specifically stated in the invoice submitted to the business entity.

31.2 General

- 31.2.1 With the exception of certain individual tax return compliance engagements, we issue and receive signed engagement letters for all tax engagements. The engagement letter sets forth a description of the services to be provided and the fee arrangements for those services, and states that the attached Standard Terms and Conditions—Tax Engagements are made a part of the engagement letter. For additional policy and guidance concerning engagement letters, refer to Chapter 21 of the *RMM—U.S.* Sample engagement letters are available on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

May 2002

31.3 Tracking Issuance and Receipt of Signed Engagement Letter

- 31.3.1 For compliance engagements and discrete consulting projects of a recurring nature, *KPMG/Atlas* is used to track the issuance and receipt of an engagement letter signed by the client. The due date for issuing the annual engagement letter is the 20th day of the month following a client's fiscal year-end (e.g., for a December 31, 2001, year-end, the engagement letter will have a January 20, 2002, due date). In the case of Form 5500 compliance engagements, the annual engagement letter is issued within four and one-half months after the client's fiscal year-end (e.g., for a December 31, 2001, year-end, the engagement letter will have a May 15, 2002, due date). After issuing the engagement letter, *KPMG/Atlas* is extended one month to remind the partner or tax managing director, and manager that the **signed** engagement letter is to be obtained from the client. When the signed engagement letter has been received, the original signed engagement letter (inclusive of any attachments) is placed in the billing file for future reference, and the record on *KPMG/Atlas* is updated as *filed*. If the engagement letter has not been received by the extended due date for the engagement letter, it will be shown as a *delinquent return*. Engagement letters to prepare or review a gift, estate or fiduciary income tax return are to be maintained in the permanent file for the client.

31.4 Compliance Engagement Letters

- 31.4.1 Ordinarily, compliance engagement letters include a separate section addressing general tax consulting services that may be requested by the client from time to time. Otherwise, a separate consulting engagement letter is issued if **any** consulting services are provided to the client during the year.
- 31.4.2 When preparing tax engagement letters for corporate compliance and consulting engagements, any services relating to our involvement in either preparing or reviewing an audit client's tax provision accrual are not included as part of the standard tax engagement letter. These services are to be covered by the KPMG assurance engagement letter.

31.5 Tax Consulting Engagements

- 31.5.1 A separate tax consulting services engagement letter is required, in addition to a general tax consulting letter, for each discrete tax consulting project (e.g., transfer pricing study, corporate acquisition or disposition, Stratecon project, IRS exam representation). If the fees for any item of tax consulting are expected to exceed \$20,000, a presumption exists that it is a discrete project for which a separate engagement letter is to be issued. As the timing of such projects usually is not predictable, it is not necessary to include a discrete project engagement letter on *KPMG/Atlas*. However, if the discrete project is of a recurring nature, the engagement letter for that project is included on *KPMG/Atlas*. Ordinarily, the due date for such recurring engagement letters is the same as that for a compliance engagement letter (e.g., April 20 for a client whose year ends March 31).

31.6 Individual Engagements

31.6.1 The engagement letter for individual income tax engagements is specifically addressed to the taxpayer, except that where the taxpayer is a minor, the engagement letter is addressed to the parent or legal guardian of the minor. For individual income tax return engagements, the engagement letter is signed and returned by the client (for joint returns, both husband and wife should sign) if gross fees are reasonably expected to be \$10,000 or more. When KPMG is engaged to prepare individual income tax returns for both the parent(s) (or legal guardian) and minor children, the fees for each tax return are combined to determine whether gross fees are \$10,000 or more. Ordinarily, only individual income tax engagement letters that will be returned by the client are tracked on *KPMG/Atlas*.

31.6.2 For estate, gift and fiduciary tax engagements, the engagement letter is signed and returned by the client in all instances, regardless of fee.

31.6.3 For individual income tax return engagements for which written acknowledgment is not requested (engagements for which gross fees, or combined gross fees where applicable, are reasonably expected to be *less than* \$10,000), the engagement letter is to include the following language:

Our receipt of your completed Organizer and/or tax data acknowledges your acceptance of the terms of this engagement.

31.7 Standard Terms and Conditions

31.7.1 Engagement letters issued by KPMG tax personnel are to include an attached Standard Terms and Conditions. Three versions of the Standard Terms and Conditions are:

- Standard Terms and Conditions—Tax Engagements
- Standard Terms and Conditions—Trade and Customs Engagements
- Standard Terms and Conditions—Tax Services Portion of Combined Audit and Tax Engagements

All versions of the Standard Terms and Conditions can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

31.7.2 While the Standard Terms and Conditions may be revised from time to time, firm personnel are not to alter the Standard Terms and Conditions for purposes of particular engagements.

31.7.3 Clients may request modifications to the Standard Terms and Conditions in certain circumstances. Any such modifications are to be set forth in the body of the engagement letter and are to be approved by the business unit professional practice partner—tax for the business unit where the lead tax engagement partner or tax managing director is located. If the lead tax engagement partner is the professional

May 2002

practice partner—tax for the business unit, then modification to the Standard Terms and Conditions is granted by the professional practice partner—tax of an adjacent business unit. A suggested form for requesting modifications can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

- 31.7.4** Because of the complexity associated with determining when a generation-skipping transfer occurs, and the large generation-skipping transfer tax (GSTT) liability that may unexpectedly arise on relatively small transfers of property, Section 9, Limitation of Liability and Indemnity, contained in the Standard Terms and Conditions—Tax Engagements, is not waived or modified for an engagement to prepare a gift, estate or fiduciary tax return for both existing and new clients.
- 31.7.5** The utilization of indemnification and limitation of liability language can reduce our exposure to both client and third-party claims. However, these provisions do not affect the engagement team's responsibility to comply with professional and firm standards while performing services. The best defense against litigation continues to be the provision of quality tax services.

Engagement Letter Approval Procedures

31.8 Department of Professional Practice—Tax Sample Engagement Letters

- 31.8.1** A sample engagement letter is provided for:
- each new tax solution announced via a *Tax Solution Alert*;
 - certain other tax solutions, strategies and services; and
 - general tax compliance and consulting services.
- 31.8.2** The Department of Professional Practice—Tax has sample engagement letters for a number of services where contingent fees or findings based fees are permissible. These letters are posted on the Department of Professional Practice—Tax homepage. Some of the services that the firm offers under findings-based fee arrangements where pre-approved engagement letters are available include:
- certain real and personal property tax services;
 - certain unemployment tax refund services;
 - certain services involving negotiations with state and local government officials regarding tax incentives; and
 - certain sales and use tax refund analysis services.
- 31.8.3** If no changes are made to a preapproved contingent fee letter, further review or approval (other than by the engagement partner) is unnecessary; however, a copy of

both the issued and signed engagement letter is forwarded to the business unit professional practice partner—tax.

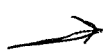
- 31.8.4** For purposes of this section and sections 31.10 and 31.11 of this chapter, the term *engagement letter* includes preapproved “initial client visit” or feasibility letters.

31.9 Modified Department of Professional Practice—Tax Preapproved Contingent Fee Engagement Letters

- 31.9.1** If modifications to a preapproved contingent fee letter, including modifications to the Standard Terms and Conditions (see paragraph 31.7.3 of this chapter), are desired, the reasons for such modifications are discussed with the business unit professional practice partner—tax where the lead engagement tax partner or tax managing director is located. The business unit professional practice partner—tax, at his or her discretion, approves the desired modifications or consults with the Department of Professional Practice—Tax thereon.
- 31.9.2** KPMG tax personnel document approval by printing and retaining (with file copy of engagement letter) the business unit professional practice partner—tax’s response.
- 31.9.3** A copy of both the issued and signed engagement letter is forwarded to the business unit professional practice partner—tax.

Engagement Letters That Have Not Been Preapproved by the Department of Professional Practice—Tax

31.10 Contingent Fee Arrangements

- 31.10.1** All tax practice contingent fee arrangements, for which a preapproved engagement letter has not been provided, are approved by the Department of Professional Practice—Tax prior to issuance.
- 31.10.2** KPMG tax personnel request approval of contingent fee arrangements from the Department of Professional Practice—Tax by submitting proposed contingent fee engagement letters via Outlook to the e-mail address, US—DPP Tax Inbox. The Engagement Letter Approval Docket is submitted with the proposed contingent fee engagement letter. The docket can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
-  **31.10.3** The Department of Professional Practice—Tax confirms whether contingent fee arrangements are in compliance with firm standards, including applicable AICPA, SEC, IRS and state accountancy rules. The Department of Professional Practice—Tax also confers with the Independence Group in the Department of Professional Practice—Assurance, as necessary, on independence issues.
- 31.10.4** KPMG tax personnel document approval by printing and retaining (with file copy of engagement letter and approval docket) the Department of Professional Practice—Tax’s response.

May 2002

31.10.5 For contingent fee engagements that may constitute lobbying under applicable state rules, refer to Chapter 64 of this manual for additional approval requirements.

31.11 Value-added Fee Arrangements

31.11.1 *Value-added fees* are fees that are based on the value of the services provided, as opposed to the time required to perform the services. For example, for purposes of this policy, a fee based on time charged at 150 percent of standard hourly rates would not be considered a value-added fee. Value-added fee arrangements are approved by the business unit professional practice partner—tax for the business unit where the lead tax engagement partner or tax managing director is assigned.

31.11.2 KPMG tax personnel document approval by printing and retaining (with file copy of engagement letter) the business unit professional practice partner—tax’s response. A copy of both the issued and signed engagement letter is forwarded to the business unit professional practice partner—tax.

31.12 Time and Expense Fee Arrangements

31.12.1 Neither Department of Professional Practice—Tax nor business unit professional practice partner—tax approval is required for engagement letters that specify fee arrangements based on time and expense, provided there is no “cap” or other adjustment factor based on results or value.

31.13 Summary of Approval Requirements

31.13.1 This chart summarizes approval requirements for the various types of engagement letters.

Type of Engagement Letter	Engagement Partner/TMD Approval Required	PPP—Tax Approval Required	DPP—Tax Approval Required (Submit to US—DPP Tax Inbox)	Copy of Issued and Signed Engagement Letter Forwarded to PPP—Tax
Letters with solely Time & Expense Fee Arrangements	X			
DPP—Tax Preapproved Contingent Fee Letter without Modifications	X			X
DPP—Tax Preapproved Contingent Fee Letter with Modifications	X	X		X
Non-DPP—Tax Preapproved Letter-Contingent Fee	X		X	X
Value-added Fee	X	X		X

31.14 Engagement Billing

31.14.1 If services billed to a business entity encompass services provided to an individual, the scope of services provided to the individual and the amount of fees for such services are specifically stated in the invoice submitted to the business entity.

Chapter 32—Fee Arrangements

32.1	Policies
32.1.1	Fee Arrangements
	Legal and professional rules and guidelines impose different restrictions on different types of fee arrangements (time and expense, value-added, contingent, commissions and referrals, and discretionary payments). These restrictions may be imposed at the federal and/or state level and may vary with the type of client (e.g., whether the client is an audit or a non-SEC audit client).
32.1.2	Unpaid Fees
	AICPA Ethics Ruling No. 52 explains when independence is impaired on account of unpaid billed or unbilled fees for services provided to audit clients.

32.2 Time and Expense Fees

32.2.1 Time and expense fee arrangements are approved by the engagement partner.

32.2.2 The engagement letter approval process is set forth in Chapter 31 of this manual.

32.3 Value-added Fees

32.3.1 KPMG can offer value-added fee arrangements for audit and non-audit clients. *Value-added fees* are fees that are based on the *value* of the services provided, as opposed to the *time* required to perform the services. One of the principal distinctions between a value-added fee and a contingent fee (see below) is that a value-added fee is not based on actual results. Thus, a value-added fee is not adjusted upward or downward if actual results differ from projected results. The amount of the fee generally is fixed before the engagement is started.

32.3.2 Value-added fee arrangements sometimes appear similar to arrangements that would be considered prohibited contingent fees. Accordingly, the particular wording used in proposals and engagement letters is very important, as is the client's understanding of the fee arrangements. The following provisions are included in value-added fee engagement letters to reduce the appearance of a contingent fee arrangement:

- a statement that our fees do not depend on the actual savings achieved or results obtained;
- fee payment schedules that relate to the timing of delivery of our services and are not established to match the timing of the projected savings to the client; and
- "termination of the engagement" language, in case the client decides, for whatever reason, not to continue with the engagement. The Standard Terms and

May 2002

Conditions—Tax Engagements includes acceptable “termination of the engagement” language. An example of acceptable language includes:

If at any time during design or implementation, you decide it is not in the best interest of [Client name] to continue with the engagement, you may notify us to that effect. [Client name] agrees to pay KPMG for time charges at standard hourly rates and expenses incurred to the date of termination of the engagement to the extent the amount so determined exceeds payments previously made for the engagement.

- 32.3.3 Services that contemplate a value-added fee may include a feasibility phase to be followed by a design and implementation phase engagement. Separate engagement letters are issued for feasibility and for design and implementation. During the feasibility phase, we generally review a client’s individual circumstances to determine whether the client may benefit from the particular services being proposed and estimate the expected benefits. The feasibility phase therefore gives us and the client an opportunity to agree on an appropriate value-added fee.

- 32.3.4 For engagements that contemplate a feasibility phase followed by a value-added fixed fee for implementation, the following language may be used **only** in the feasibility phase engagement letter:

At the completion of our feasibility analysis, we will report our conclusions to [Company Name] and our recommended action steps for design and implementation of [solution or service]. Should [Company Name] decide to proceed with design and implementation, we will issue a separate engagement letter that will include a fixed fee for the design and implementation phases. The fixed fee determined based on KPMG’s investment in developing our [solution or service], value, complexity of the engagement, and resource utilization. Our experience with similar engagements has been that our fixed fee generally has approximated [XX] percent of the projected benefits [or savings] for the first year [or other period] following implementation. The amount of the fee will not depend on actual benefits [or savings].

- 32.3.5 The engagement letter approval process is set forth in Chapter 31 of this manual.

Contingent Fees

32.4 General

- 32.4.1 Firm professionals comply with AICPA Rule 302, the applicable state accountancy and lobbying rules, and the applicable SEC rules (for SEC audit clients) with respect to contingent fee arrangements for tax services.

32.5 AICPA Rule 302

- 32.5.1** Rule 302 of the AICPA *Code of Professional Conduct* defines a *contingent fee* as a fee established for the performance of any service pursuant to an arrangement where (a) no fee is charged unless a specified result is attained or (b) the amount of the fee is otherwise dependent upon the results of the services.
- 32.5.2** Generally, under AICPA Rule 302, contingent fees are permitted for services provided to non-audit clients but **prohibited** for services to audit clients.
- 32.5.3** A contingent fee cannot be charged for the preparation of an **original return** for any client, audit or non-audit, even if the underlying issue could be expected to be reviewed by the taxing authority. *Preparation* of an original return includes giving advice on transactions that already have occurred at the time the advice is given.
- 32.5.4** A contingent fee cannot be charged for the preparation of an amended tax return or claim for refund for any client, audit or non-audit. (See, however, the exception for “findings-based fees,” below.)
- 32.5.5** For purposes of AICPA Rule 302, fees are not regarded as being contingent if fixed by the courts or other public authorities or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.
- 32.5.6** In the case of tax matters, a “contingent” fee for purposes of AICPA Rule 302 **excludes** a fee based on the findings of governmental agencies provided there is a reasonable expectation, at the time of the fee arrangement, of substantive consideration of the underlying tax matter by a governmental agency. Fees based on the findings of governmental agencies in tax matters are generally referred to as *findings-based fees*.

32.6 State Rules

- 32.6.1** In addition to complying with AICPA Rule 302, fee arrangements must be in compliance with the applicable state accountancy laws. The majority of the states conform to Rule AICPA 302. Most states that do not conform prohibit contingent fees for services to both audit and non-audit clients. With the exception of Alaska, Florida (for federal amended returns), Wisconsin (for amended returns and claims for refunds for audit clients) and Vermont (for amended returns and claims for refunds by any client), all states permit findings based fees in tax matters to the extent such fees are permitted by AICPA Rule 302. The accountancy rules of the following states are examined to determine whether a contingent fee is permissible:
- the state where KPMG will perform most of the work for the engagement;
 - the state where KPMG will manage the engagement; and
 - the state where KPMG will sign the engagement letter.
- 32.6.2** Notwithstanding that the accountancy rules of many states permit contingent fees to be charged to non-audit clients or findings-based fees to be charged to audit and non-audit

May 2002

clients, the **lobbying rules** of many states prohibit such fees for lobbying activities (including lobbying activities involving tax matters). Thus, a fee arrangement that would otherwise be permitted under AICPA Rule 302 and the applicable state accountancy rules may nevertheless be prohibited by the particular state's lobbying rules.

32.6.3 The engagement letter approval process is set forth in Chapter 31 of this manual.

32.6.4 Additional guidance on contingent fee arrangements is set forth in Chapter 21 of the *RMM—U.S.*

32.7 SEC Rules

32.7.1 SEC Independence Rule 2-01(c)(5) addressing contingent fee arrangements is virtually identical to AICPA Rule 302. Unless the SEC should state otherwise at some point in the future, a findings-based fee (described above) that is permissible under AICPA Rule 302 should also be permitted for SEC audit clients.

32.7.2 The SEC takes a more expansive view of the contingent fee rule than the AICPA. The rule can apply where we receive a contingent fee or commission with respect to a service or solution provided to an SEC audit client, even though we might not directly provide the service or solution to the SEC audit client and even though we might not receive a contingent fee or commission from an SEC audit client. If our services are provided for the purpose of assisting our client in its provision of services or solutions to its customers, then the SEC rules are implicated to the extent our client's customers are our SEC audit clients. In such a case, we could not charge a contingent fee for our services to our client with respect to its provision of services or solutions to our SEC audit client.

32.7.3 Although the definition of a contingent fee refers to finding or result, the SEC views a fee that is dependent on a particular event, such as a closing of a transaction, to be contingent.

32.7.4 Although the definition of *contingent fee* is virtually identical under AICPA and SEC rules, there is a significant difference in the definition of "audit client." For purposes of Rule 302, an "audit client" is the entity to whom we provide attest services. However, for purposes of SEC Independence Rule 2-01(c)(5), an "audit client" is the entity to whom we provide services **and** any "affiliates" of that entity. The term *affiliate of an audit client* means:

- an entity which has control over the audit client, or over which the audit client has control, or which is under common control with the audit client (e.g., parents, subsidiaries and sister companies);
- an entity over which the audit client has significant influence, unless the entity is not material to the audit client;
- an entity that has significant influence over the audit client, unless the audit client is not material to the entity; or

- each entity in an investment company complex when the audit client is an entity that is part of the investment company complex.

- 32.7.5** Generally, a contingent fee cannot be charged to an entity designated as a *restricted entity* in the KPMG Independence Compliance System (<http://its.us.kpmg.com>), unless the fee meets the definition of a *findings-based fee*.
- 32.7.6** A contingent fee (other than a permitted findings-based fee) may not be charged to certain entities, including individuals, who are not designated as restricted entities but are in the position of significant influence or associated with the entity in a decision-making capacity such as officers, directors or substantial shareholders. For example, a contingent fee could not be charged to the CEO of an SEC audit client, as the CEO would be in a position of significant influence over the audit client.
- 32.7.7** As the determination of whether the findings-based fee exception to the definition of contingent fees applies depends on the facts and circumstances of a particular case, the advance approval of the Department of Professional Practice—Tax is obtained before entering into fee arrangements with an audit client where the fee is expressed as a percentage of tax savings or is dependent upon a particular event or result occurring.
- 32.7.8** A detailed discussion of the term *affiliate of an audit client* is set forth in Chapter 12 of the *RMM—U.S.*

Commissions and Referral Fees

32.8 General

- 32.8.1** Firm professionals comply with AICPA Rule 503, the applicable state accountancy rules and the applicable SEC rules (for SEC audit clients) with respect to commissions and referral fee arrangements for tax services.

32.9 AICPA Rule 503

32.9.1 Definitions of Terms

Commission: Any item of value given or received by a CPA to or from any third party in return for recommending, referring or suggesting the purchase of any product or service.

Referral Fee: A fee received by a CPA for referring or recommending any service of another CPA to any person or a fee paid by a CPA to obtain a client.

- 32.9.2** Under AICPA Rule 503, commissions are permitted with respect to non-audit clients, provided they are disclosed, but prohibited with respect to audit clients.
- 32.9.3** The *receipt* of referral fees for the referral of a client to an entity *other than another CPA firm* is treated in the same manner as commissions stated in paragraph 32.9.2 above.

May 2002

32.9.4 The *receipt* of a referral fee for referring a client to *another CPA firm* is permitted for both audit and non-audit clients provided the receipt of the fee is disclosed to the client.

32.9.5 The *payment* of a referral fee to another entity for referring a client to KPMG is permitted, for both audit and non-audit clients, provided the payment of the fee is disclosed to the client.

32.10 State Rules

32.10.1 In addition to complying with AICPA Rule 503, commissions and referral fee arrangements must be in compliance with applicable state accountancy laws.

32.10.2 Additional guidance on commissions and referral fee arrangements is set forth in Chapter 21 of the *RMM—U.S.*

32.10.3 The engagement letter approval process for commissions and referral fee arrangements is similar to the approval process for contingent fee arrangements outlined in Chapter 31 of this manual.

32.11 SEC Rules

32.11.1 SEC Independence Rule 2-01(c)(5) states:

An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

32.11.2 The SEC generally prohibits the receipt of a “commission” relating to or from an SEC audit client of the firm under any circumstances.

32.11.3 See paragraph 32.7.4 for the SEC’s definition of *audit client*.

32.12 Discretionary Payments

32.12.1 Where a contingent fee is not permissible and a fixed fee is charged, a discretionary payment is permissible provided the discretionary payment is paid at the sole discretion of the client and further provided, the discretionary payment is not based on actual savings achieved. The amount of the discretionary payment cannot exceed the amount of the nondiscretionary fee quoted in the engagement letter.

32.12.2 The following is sample discretionary payment engagement letter language:

An additional payment, not to exceed \$_____ will be paid upon the discretion of [Client name] based upon criteria attached. This discretionary payment will not depend upon the actual savings achieved.

32.12.3 The following is attached to an engagement letter that provides for a discretionary payment:

The following list contains the factors that [Client name] may consider when exercising its discretion in determining whether any discretionary payment will be remitted to KPMG relating to the [type] engagement. Such factors are illustrative only and do not purport to constitute an exhaustive list:

- *Timeliness of product delivery;*
- *Open and frequent communication with [Client name] relating to project developments;*
- *Professional nature of deliverables;*
- *Complexity of work performed;*
- *Commitment of trained and experienced professionals to the project;*
- *Responsiveness to [Client name] concerns;*
- *Flexibility of project design;*
- *Flexibility of project implementation;*
- *Completeness of documentation;*
- *Collaborative spirit of KPMG delivery team; and*
- *Such other factors as [Client name] may consider.*

32.12.4 We cannot enforce payment of a discretionary payment since it is at the pure discretion of the client, therefore, these arrangements substantially increase our risk of non-collection. We carefully consider the facts and circumstances of the related engagement and our relationship with the client in providing for a discretionary payment.

32.12.5 All engagement letters that provide for a discretionary payment are to be approved by the Department of Professional Practice—Tax prior to issuance.

32.12.6 Additional guidance on discretionary fee arrangements is set forth in Chapter 21 of the *RMM—U.S.*

May 2002

32.13 Unpaid Fees

- 32.13.1** Unpaid billed or unbilled fees can impair the firm's independence under both AICPA and SEC independence rules. Further discussion of these rules is set forth in Chapter 12 of the *RMM—U.S.*
- 32.13.2** On occasion, it may be necessary to commence legal action against a client for nonpayment of fees or other issues concerning the provision of tax services. As any legal action is a sensitive matter, the Office of General Counsel is to be consulted before engaging outside counsel, as specified in Chapter 31 of the *RMM—U.S.*

Chapter 33—Tax Engagement Responsibilities and Files

33.1	Policies
33.1.1	Engagement Team Responsibilities
	The engagement team consists of partners, tax managing directors, managers and professional staff who have appropriate levels of knowledge, skills and experience for the needs of the client and the engagement undertaken.
33.1.2	Tax Engagement Files
	We maintain appropriate files for all tax engagements and follow firm procedures with respect to the retention of different types of materials.

Engagement Team Responsibilities

33.2 Overall Engagement Responsibilities

- 33.2.1** The engagement team consists of partners, tax managing directors, managers and professional staff who have appropriate levels of knowledge, skills and experience for the needs of the client and the engagement undertaken. The engagement partner or tax managing director determines the overall size and composition of the engagement team and the roles of the members of the engagement team.
- 33.2.2** As discussed in Chapter 10 of the *RMM—U.S.* and Chapter 21 of this manual, members of the engagement team fulfill their responsibilities in accordance with firm policies, professional standards and applicable laws and regulatory requirements. When providing tax related services to audit clients of the firm, members of the engagement team comply with the applicable rules relating to maintaining firm independence as contained in Chapter 12 of the *RMM—U.S.* and consult with the Department of Professional Practice—Tax or the business unit professional practice partner—tax as appropriate.
- 33.2.3** The AICPA's *Statements on Standards for Tax Services*, *Statements on Responsibilities in Personal Financial Planning*, and Treasury Department Circular 230 are among the standards that apply to providers of tax services. Treasury Department Circular 230 is reproduced in most major federal income tax services (*CCH Standard Federal Tax Reporter*, *RIA United States Tax Reporter* and others). These documents, with the exception of the *Statements on Responsibilities in Personal Financial Planning*, can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

May 2002

33.3 Engagement Partner or Tax Managing Director Responsibilities

- 33.3.1** The tax services engagement partner or tax managing director is responsible for the technical quality of tax services and determines that the engagement is conducted in accordance with KPMG policies and professional requirements.

Tax Engagement Files**33.4 General**

- 33.4.1** We maintain appropriate files for all tax engagements. For example, our tax compliance engagements, work papers files, tax return files and correspondence files are all appropriate. If we perform both tax compliance and tax consulting services for a client, the same correspondence file and permanent file (if any) may be used for both types of engagements.
- 33.4.2** Refer to Chapter 24 of the *RMM—U.S.* for additional policies and guidance with respect to the retention of client-specific information. Different types of engagement files require different retention periods (e.g., permanent files are retained indefinitely whereas tax work papers files are retained for six years); therefore, separate files are maintained (i.e., client correspondence, tax work papers and permanent file information are not contained in a single file).
- 33.4.3** Refer to Chapter 50 of this manual with respect to third-party access to client-related material.
- 33.4.4** Refer to Chapter 11 of the *RMM—U.S.* for a discussion on our duty to maintain the confidentiality of client and former client information.

33.5 Special Project Work Papers Files

- 33.5.1** Often, special projects are provided to clients by solution groups (e.g., SALT, Stratecon, M&A, ECS). These engagements result in a separate set of work papers that support the project. The personnel responsible for retaining special project work papers files and complying with the firm's record retention policies are the solution groups, who will coordinate with the client's engagement team, if different, regarding retention of the files.
- 33.5.2** Special requirements for multi-firm engagement files are set forth in Chapter 37 of this manual.
- 33.5.3** Multi-office engagements involving participation of more than one KPMG offices within the United States are subject to file maintenance requirements that are similar to those discussed in Chapter 37 of this manual.

33.6 Tax Consulting Work Papers File

- 33.6.1** In some cases, a work papers file may be needed to maintain documentation of information used in providing tax consulting services. If a tax consulting work papers file is maintained, it is maintained separately from the tax compliance work papers file.

33.7 Tax Compliance Work Papers File

- 33.7.1** The tax compliance work papers file ordinarily contains the work papers and copies of pertinent client data used in providing compliance and compliance-related services.
- 33.7.2** The work papers file for a tax return ordinarily contains the information necessary to reconcile amounts shown in the client's records to amounts shown in the tax return. For example, the work papers file for a corporate compliance engagement ordinarily includes a reconciliation of the income tax expense for audited financial statement (book) purposes to the total income tax as shown on the tax return.
- 33.7.3** To facilitate efficient work paper access and record retention procedures, a new tax compliance work papers file is created for each tax year. Since the record retention periods for tax returns and tax work papers differ, the work papers file is separate from the tax return file.

33.8 Tax Return File

- 33.8.1** The tax return file contains a duplicate copy of every final federal, state and local tax return presented to a client for filing. The tax return docket, transmittal letter and filing instructions also are included in the tax return file.

33.9 Permanent File

- 33.9.1** In the course of a client relationship, it may be appropriate to retain in a permanent file certain items of continuing significance relevant to a client's tax situation or business operations. Examples of such items include the following:
- carryforward items that cannot be addressed adequately in the work papers;
 - reports of examinations by tax authorities;
 - copies of elections with continuing significance;
 - rulings and similar documents issued to the client that have continuing significance;
 - organizational documents;
 - contracts and agreements;
 - signed engagement letters for the preparation or review of gift, estate, or fiduciary income tax returns;

May 2002

- copies of wills and trust instruments;
- Generation-Skipping Transfer Tax (GSTT) allocation information; and
- for corporate engagements, a cumulative Schedule M-1 (Reconciliation of Income (Loss) per Books with Income per Return) analysis and a reconciliation of cumulative Schedule M-1 amounts to year-end tax/book basis differences.

33.10 Correspondence File

- 33.10.1** A correspondence file ordinarily contains copies of letters received, copies of letters sent, memoranda of oral advice and written memoranda on tax-related matters. All correspondence originating from KPMG exhibits the proper approvals (policies and guidance with respect to tax-related correspondence are set forth in Chapter 41 of this manual).

33.11 Billing File

- 33.11.1** A billing file ordinarily contains final copies of invoices sent to clients, KPMG/Gemini schedules supporting the engagement budget and pricing, and signed engagement letters received from the client.

Chapter 34—Large Case Project Management

34.1 Policies

An appropriate level of project management will be required for all tax engagements, regardless of practice, where it is anticipated that the total fees will or could exceed \$500,000.

The approval sign-offs are documented on the Tax Project Management Approval Form, which is maintained in the billing file.

34.2 General

34.2.1 An appropriate level of project management will be required for all tax engagements, regardless of practice, where it is anticipated that the total fees will or could exceed \$500,000. The implementation of this policy is intended to advance our achievement of operational excellence by enabling:

- collaboration among team members and service lines on:
 - engagement scope,
 - resources,
 - fee amount and allocations, and
 - billing and collection management;
- more efficient deployment of resources to address client needs;
- achievement of clarity and accountability with respect to key client milestones;
- communication among team members and appropriate leadership throughout the engagement; and
- an appropriate collaborative means to address scope changes, technical issues and professional practice concerns that inevitably arise during the course of the engagement.

34.2.2 The approval sign-offs are documented on the Tax Project Management Approval Form, which is maintained in the billing file. The Tax Project Management Approval Form can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

May 2002

34.3 Process Overview**34.3.1** The planning process should generally follow the following steps:

- the Engagement Leader and Project Manager work with the senior engagement team member from each participating service line (collectively, the “Engagement Management Team”) to create an initial Project Plan;
- client agreement is secured as to scope, deliverables, milestones and fee proposal for engagement;
- review of the initial Project Plan by either the area managing partner—tax (AMP) for Authorized Projects (i.e., certain tax new business development projects) or the Leadership Review Group (defined below) for “live” engagements;
- reconcile, as needed, any changes to the initial Project Plan as a result of client discussions to “finalize” the plan;
- approval of the Project Plan by the Leadership Review Group; and
- implement work streams in the Project Plan.

34.4 Project Plan**34.4.1** The engagement team, under the direction of the Engagement Management Team, will collaboratively create a Project Plan that includes the following:

- key work streams and significant underlying tasks;
- major engagement milestones and deliverables;
- clear division of responsibilities by service line and area;
- staff level and estimated hourly rate of individuals required to perform tasks;
- budgeted hours required to achieve each of the major engagement milestones and deliverables broken out by individual; and
- communication Plan.

34.4.2 A sample work plan approach can be found in Tax Scope (<http://taxscope.kworld.kpmg.com/taxscope/>) or in the toolkits for certain solutions (see, e.g., the SALT SBS delivery model at <http://taxkm.us.kworld.kpmg.com/taxsite/salt/stm/sbs/delmodel1.htm>). Alternatively, *Microsoft Project*TM is a scalable software package that can be used to expeditiously create short work plans for straightforward projects to highly sophisticated work plans for larger projects. Existing work plan templates may, in many instances, require modification to include all of the items indicated above.

- 34.4.3 Where possible, the engagement team identifies the individual partners, managers and staff they anticipate utilizing for the engagement. Local resources should be utilized whenever possible. Ultimately, the National Solution Champion is responsible for ensuring that the resources have the requisite skills to properly complete the engagement.
- 34.4.4 The Project Plan anticipates and specifically addresses the role and scope of services to be performed by members of the Tax Controversy Service (TCS) practice to mitigate both the client's and firm risks and ensure compliance with tax policy on utilization of the TCS practice on engagements of this size. Additional guidance on the involvement of TCS professionals in certain engagements is set forth in Chapter 42 of this manual.
- 34.4.5 Consideration is given in the Project Plan to ensuring that adequate long-term working relationships will be developed with the client by including the appropriate tax services partner (TSP)/engagement services partner (ESP)/tax managing director (TMD) or other local resource on the engagement team.
- 34.4.6 The Project Plan addresses commitments for post-implementation deliverables and the impact that those commitments will have on future revenue recognition and allocations. Consideration is given to including other solution groups in the post-implementation process as an investment to identify future opportunities when practical from both KPMG and the client's perspective.
- 34.4.7 The Project Plan will provide the Leadership Review Group with a framework to review and approve the scope of the engagement, specific resources required and the financial budget allocated by area and service line.
- 34.4.8 The Project Plan is kept current by the engagement team to reflect approved changes to the engagement scope or resources.
- 34.5 **Communication Plan**
- 34.5.1 The Engagement Management Team communicates, by meeting or conference call, at least once a week during the course of the engagement to review results against the Project Plan and to identify any potential scope changes, resource changes, technical issues and/or professional practice concerns. Where there are scope changes, resource changes, technical issues and/or professional practice concerns, an e-mail is sent to the Leadership Review Group with the planned resolution that addresses the impact of any changes to prior agreements. The Leadership Review Group immediately convenes to approve or propose revisions to allow the engagement team to move forward. As part of the Project Plan, the Leadership Review Group can authorize the Engagement Management Team to address certain changes that are within an agreed-to range (the *delegated range*). The Leadership Review Group should abide by agreements reached by the Engagement Management Team within the delegated range.

May 2002

34.6 Leadership Review Group

34.6.1 The Leadership Review Group for the engagement discusses and comes to an agreement with respect to the Project Plan for each engagement meeting the \$500,000 threshold. The Leadership Review Group is comprised of:

- the area managing partner—tax where the client headquarters (or affected division headquarters where applicable) is domiciled;
- each affected National and/or Area Service Line Leader; and
- the National Solution Champion.

34.6.2 Any terms and conditions that are not agreed to by the Leadership Review Group will be resolved by agreement of the AMP and National Solution Champion and be reflected in writing in the Project Plan. As a last resort, any remaining disagreements will be resolved, with finality, by the vice chairman—tax operations and be reflected in writing in the Project Plan. Each member of the Leadership Review Group must sign off on the project plan before the engagement is commenced. The National Solution Champion is responsible for finalizing the project plan one week after submitting it to the leadership review group for comment and sign-off. If no comments are received within this one week period, then the last draft of the initial project plan will become the final project plan. Any changes to the project plan, including budget changes, must be approved by the Leadership Review Group.

34.7 Engagement Management Team

34.7.1 The Project Plan provides for an Engagement Management Team to be comprised of the Engagement Leader (usually area solution champion or other service line partner/senior manager that will be responsible for feasibility and/or implementation), the TSP/ESP/TMD, one representative from each service line involved, and the project manager. The Engagement Leader is responsible for developing the Project Plan and the day-to-day management of the engagement against the Project Plan.

34.8 Financial Management of Engagement

34.8.1 The Leadership Review Group determines the number of contracts and proper contract valuations based on the initial budget estimates. The names of the individual partners and managers under which the contracts will be established are agreed to in advance of commencing the engagement.

The Leadership Review Group must also approve:

- the timing and amount of hours and related revenue that will be recognized as it relates to time previously spent in feasibility that is held in authorized project contracts;
- any other allocations out of development contracts;

- the allocation and timing of any expected premiums to be recognized over the course of the engagement; and
- the appropriate allocation of cash collections to the contracts that will be established.

34.8.2 Generally, the cash allocations reflect the expected timing of responsibilities as established in the Project Plan to reduce the investment lockup of the engagement. Time charges and contracts not approved in the approved project plan will not have cash applied against them.

Chapter 35—Confidentiality, Exclusivity and Privacy

35.1 Policies

35.1.1 KPMG Agrees Not To Disclose Client and/or Third-party Information

Confidentiality agreements with respect to client and/or third-party information are approved by the business unit professional practice partner—tax.

In executing such a confidentiality agreement, an agreement substantially similar to one of the firm's standard agreements generally is used, and any significant variations are reviewed by the Office of General Counsel and the Department of Professional Practice—Tax prior to execution.

35.1.2 Client Agrees Not To Disclose KPMG Information

Firm personnel are not to offer federal income tax solutions, strategies or other federal income tax services to clients or potential clients under "conditions of confidentiality." Any exception to this policy requires the express permission from the partner in charge of the Department of Professional Practice—Tax. "Conditions of confidentiality" include oral or written confidentiality agreements and claims of exclusivity.

All firm presentation materials, client engagement letters, initial client visit letters or other similar correspondence with clients and potential clients involving federal income tax solutions, strategies or services are to include a statement that permits clients to disclose the structure and tax aspects of the transaction. To the extent that the Standard Terms and Conditions—Tax Engagements are expressly made a part of an engagement letter, the required statement will automatically be included in the engagement letter. Any exception to this policy requires the express permission from the partner in charge of the Department of Professional Practice—Tax.

In those limited circumstances where a claim of exclusivity is used in connection with a strategy that may result in a corporate federal income tax benefit, all firm presentation materials, client engagement letters, initial client visit letters or other similar correspondence with clients and potential clients are to include a statement that permits clients to disclose the structure and tax aspects of the transaction and all materials provided to the client related to the structure and tax aspects.

35.1.3 Privacy Notices to Individuals

Pursuant to regulations issued under the Gramm-Leach-Bliley Act (GLB) regulations, firm personnel are to provide a privacy disclosure notice to new individual clients at the time the customer relationship is established and are to provide an annual privacy notice to existing individual customers.

May 2002

KPMG Agrees Not To Disclose Client and/or Third-party Information**35.2 General**

- 35.2.1** Clients may ask for a confidentiality (or nondisclosure) agreement as a condition of our being engaged to perform certain services. While some of these agreements impose no greater standard than that embodied in the AICPA's *Code of Professional Conduct*, others contain extremely broad wording that, for example, could be interpreted as restricting us from performing similar services for other clients in the same industry.
- 35.2.2** Other parties, particularly those promoting certain tax solutions and strategies, may request a confidentiality or nondisclosure agreement. They may ask for such an agreement prior to holding any meaningful discussions relevant to the particular solution or strategy.
- 35.2.3** Confidentiality agreements should be avoided whenever possible and, if entered into, such agreements must be appropriate for the firm on an overall basis, not simply for the purpose of a single engagement.
- 35.2.4** A confidentiality agreement must specify the engagement to which it relates. For example, we would not execute a confidentiality agreement relating to "Tax advice provided to ABC Bancorp"; we would be willing to execute an agreement relating to "Advice provided to ABC Bancorp in connection with the preparation of its federal and state income tax returns for the year ended December 31, 20XX."
- 35.2.5** Confidentiality agreements should not prevent the firm from fulfilling its professional responsibilities as independent auditors to the client. For example, we would not enter into an agreement prohibiting a partner performing a tax engagement from sharing information about the client with the audit engagement partner nor should the agreement restrict the firm from performing the normal review process, such as concurring partner review and the Quality Performance Review.
- 35.2.6** Before entering into a confidentiality agreement, we determine that the information to be covered by the confidentiality restriction is clearly and narrowly defined. Additionally, it should only cover information that is obtained by the firm following the date that the agreement is entered into. Information that has been independently obtained or developed by the firm cannot be included. The obligation ends when the information becomes public knowledge. It would also be terminated should the information be disclosed to the firm by a third party not subject to a restriction on disclosure.
- 35.2.7** A confidentiality or nondisclosure agreement in which KPMG agrees not to disclose client and/or third-party confidential information may only be executed after review and approval by the business unit professional practice partner—tax.
- 35.2.8** In executing a confidentiality agreement, an agreement substantially similar to one of the firm's standard agreements generally is used. The firm's two standard confidentiality agreements are available on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>. The

standard agreement that normally will be applicable is the “Agreement Regarding Receipt of Confidential Information.” Generally, the “Agreement Regarding Mutual Disclosure of Information” should not be used where a federal income tax strategy is involved.

- 35.2.9 If the business unit professional practice partner—tax determines there are any significant variations from the firm’s standard agreements, the Office of General Counsel and the Department of Professional Practice—Tax are consulted prior to execution.
- 35.3 **Maintaining Confidentiality**
 - 35.3.1 The standard of care that the firm is normally required to exercise pursuant to confidentiality agreements is the same degree of care and discretion that the firm exercises with regard to its own confidential information.
 - 35.3.2 The partner who executes the confidentiality agreement is responsible for compliance with its terms by the firm and firm personnel. The partner’s discharge of this responsibility may be evidenced by having the members of the engagement team sign a declaration that they have read the confidentiality agreement and will comply with its terms. This declaration may be filed with the confidentiality agreement in the client correspondence file.

Client Agrees Not To Disclose KPMG Information

- 35.4 **General**
 - 35.4.1 Temporary Treasury Regulation Section 301.6111-2T issued on February 28, 2000, (and revised in August 2000 and August 2001) generally requires that confidential corporate tax shelters be registered with the IRS. For this purpose, a *confidential corporate tax shelter* is any entity, plan, arrangement or transaction (a) that has a significant purpose of avoiding or evading federal income tax for a direct or indirect corporate participant, (b) that is offered under written or oral “conditions of confidentiality,” and (c) for which promoters may receive fees in excess of \$100,000 in the aggregate.
- 35.5 **Federal Income Tax Services Are Not Offered Under Conditions of Confidentiality**
 - 35.5.1 As many of the federal income tax strategies we offer to corporate clients and potential clients might meet the definition of “corporate tax shelter,” firm personnel are not to offer federal income tax solutions, strategies or other federal income tax services to clients or potential clients under conditions of confidentiality. Further, no conditions of confidentiality are to be placed upon parties other than clients or potential clients, such as investment banks or law firms, relative to discussions with or review by such parties of any federal income tax solutions, strategies or services that are, or will be, offered to clients.

May 2002

- 35.5.2** Any exception to this policy (e.g., for a solution or strategy that will only be offered to individuals and will not have the potential effect of reducing or deferring federal income tax for a corporation, or for a solution that is registered) requires the express permission of the partner in charge of the Department of Professional Practice—Tax.

35.6 Conditions of Confidentiality and Claims of Exclusivity

- 35.6.1** “Conditions of confidentiality” exist if an offeree’s disclosure of the structure or tax aspects of a transaction is limited in any way by an express or implied understanding or agreement with the promoter. In addition, an offer will be considered made under conditions of confidentiality if “the transaction is claimed to be proprietary to the tax shelter promoter or any party other than the offeree.”

- 35.6.2** “Conditions of confidentiality” therefore could include: a formal confidentiality or nondisclosure agreement, a statement in an “initial client visit” or engagement letter that the client agrees to keep the strategy confidential; a statement in presentation slides or oral comments requesting the client to keep the strategy confidential; and any written or oral statement that the strategy is proprietary or exclusive to KPMG.

- 35.6.3** An engagement letter (or other agreement or client letter) that provides that a client will pay us a specified fee if it decides to implement a particular strategy irrespective of whether the client engages us for services in connection with the strategy is a claim of “exclusivity” under the August 11, 2000, changes to the temporary regulations. To this end, the following language is a claim of exclusivity:

If Client decides not to engage KPMG in connection with design and implementation of the strategy, but implements the strategy within three years of today's date, Client will pay a fee of \$X to KPMG.

- 35.6.4** Claims of exclusivity are not to be used under any circumstances for engagements involving SEC audit clients due to independence considerations. A claim of exclusivity generally is to be avoided for engagements not involving SEC audit clients. The use of a claim of exclusivity in a presentation, ICV or feasibility letter, or engagement letter not involving an SEC audit client, with respect to an income tax strategy that may result in a corporate federal income tax benefit, requires advance approval of the applicable business unit professional practice partner—tax or of the Department of Professional Practice—Tax.

35.7 Required Use of “Presumption” Language Permitting Client To Disclose

- 35.7.1** Under the August 2000 version of the Section 301.6111-2T regulations, there ordinarily is a presumption that the tax shelter is not offered under conditions of confidentiality if the promoter provides express written authorization to each offeree to disclose the structure and tax aspects of the transaction. The August 2001 changes to the regulations make certain revisions to the “presumption” language.

- 35.7.2** Given the broad language of the regulations, all presentation materials, client engagement letters, initial client visit letters, feasibility letters or other similar

correspondence with clients and potential clients involving federal income tax solutions, strategies or services are to include the following statement:

You (and each of your employees, representatives or other agents) are expressly authorized to disclose the structure and tax aspects of the transaction to any and all persons, without limitation of any kind on such disclosure.

- 35.7.3** To the extent that the Standard Terms and Conditions—Tax Engagements are expressly made a part of an engagement letter, the required statement will automatically be included in the engagement letter.
- 35.7.4** Any exception to this policy (e.g., for a solution or strategy that will only be offered to individuals and will not have the potential effect of reducing or deferring federal income tax for a corporation, or for a solution that is registered) requires the express permission of the partner in charge of the Department of Professional Practice—Tax.
- 35.7.5** In view of the August 2001 changes to the regulations, in those limited circumstances where a claim of exclusivity is used in connection with an income tax strategy that may result in a corporate federal income tax benefit, the broader “presumption” language below is to appear in all presentation materials, client engagement letters, ICV letters, feasibility letters or other similar correspondence issued on or after the date the claim of exclusivity is made, with the client or potential client to whom the claim of exclusivity involving the strategy was made. This language is as follows:

You (and each of your employees, representatives or other agents) are expressly authorized to disclose to any and all persons, without limitation of any kind, the structure and tax aspects of the transaction, and all materials of any kind (including tax opinions or other tax analyses) that are provided to you related to such structure and tax aspects.

- 35.7.6** Where a claim of exclusivity has been made in connection with an income tax strategy that may result in a corporate federal income tax benefit, the engagement letter with the client with respect to such strategy should indicate that the Standard Terms and Conditions—Tax Engagements are expressly made a part of the engagement letter, except that Section 8 thereof is modified to read as above.

35.8 Application to State and Local Tax Engagements

- 35.8.1** The policy set forth in this chapter applies to a state and local tax solution, strategy or service only if a state has adopted the federal confidential corporate tax shelter regulations or if implementation of the solution, strategy or service could result in a reduction or deferral of federal corporate income tax.

May 2002

Privacy Notices to Individuals**35.9 General**

- 35.9.1** The Gramm-Leach-Bliley Act (GLB) includes privacy provisions relating to consumers' financial information. The privacy provisions of GLB apply to **financial institutions**. Regulations implementing GLB currently define the term *financial institutions* to include firms providing financial or investment advisory services including tax planning, tax return preparation and individual financial management planning. Accordingly, CPA firms providing tax or advisory services are covered by GLB even though CPAs are already required under professional rules and under rules of the Internal Revenue Service and other tax authorities to keep client information confidential.
- 35.9.2** The aspect of the GLB regulations of most relevance to the tax practice is a requirement to provide privacy notices to customers. *Customers* are **individuals** with whom we have an **ongoing** relationship to provide **personal** tax, investment advisory or financial planning services. This includes individuals to whom we provide such services even though we may not have a direct client relationship with them. Examples of indirect client relationships that fall within the definition of *customers* include "expatriates" and "foreign nationals" covered by an International Executive Services (IES) engagement with their employer and executives covered by an employer-sponsored financial planning engagement.
- 35.9.3** References herein to "KPMG" and "we" are to the U.S. firm of KPMG LLP (and KPMG Investment Advisors). A copy of the KPMG Privacy Notice is not to be provided to direct and indirect individual clients by foreign member firms of KPMG International. Where services are provided to an individual client partly by a foreign member firm and partly by the U.S. firm (e.g., foreign member firm prepares an expatriate's income tax return and U.S. firm prepares the expatriate's tax equalization computations and/or provides tax advice to the expatriate), tax personnel of the U.S. firm are to take steps to provide the KPMG Privacy Notice to the individual client (directly or indirectly through the individual's employer).
- 35.10 Direct Client Relationships**
- 35.10.1** Pursuant to the GLB regulations, firm personnel are to provide a privacy disclosure notice to new individual clients at the time the customer relationship is established and are to provide an annual privacy notice to existing individual customers. A current version of KPMG's Privacy Notice is posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 35.10.2** If the annual notice was not provided to an individual income tax return client with the engagement letter for the individual income tax returns, a copy of the notice may be included with the completed income tax return sent to the taxpayer. The tax return transmittal letter (where the notice is provided at the time of delivery of the completed tax return) or other accompanying written communication is to include the following language:

Enclosed is a notice regarding KPMG's privacy policies. Under our privacy policies, we may share information with KPMG Investment Advisors and with other affiliates solely as needed to provide services to you, unless you direct us otherwise.

35.11 Indirect Client Relationships

- 35.11.1** In the case of an employer-sponsored program where we provide tax or investment advisory services to a large number of indirect individual clients, the employer, rather than KPMG, may handle the distribution of the KPMG Privacy Notice, provided we receive written confirmation that it has been done. For example, the sample IES Program Engagement Letter on the Department of Professional Practice—Tax homepage has been revised to include the following section:

Privacy

We are enclosing the KPMG Privacy Notice. You agree to provide a copy of the enclosed notice to all authorized international assignees and to inform us when that has been done.

- 35.11.2** Written confirmation from the employer that the privacy notice has been delivered to all persons covered by the employer-sponsored program satisfies our requirement to provide an initial privacy notice to new indirect individual clients under the program. If such written confirmation is not received, a copy of the notice is mailed to new indirect individual clients under the program as soon as practicable.
- 35.11.3** If the employer did not provide the annual notice to individual tax clients, a copy of the notice with the completed income tax return may be sent to those indirect individual clients for whom we prepare income tax returns and the language described in paragraph 35.10.2 is used in the transmittal letter.

Chapter 36—Engagement Information Form

36.1 Policies

The engagement partner, principal or tax managing director, or his or her designee, is to submit an Engagement Information Form for each covered engagement at the time an engagement letter is issued to a client and to provide additional information shortly after the signed engagement letter is received from the client. A covered engagement generally is any engagement for the provision of tax services that is not on the Exceptions List and for which we reasonably expect to receive fees of \$25,000 or more.

36.2 General

- 36.2.1** Firm professionals are to follow the procedures described below to assist with the firm's responsibility with respect to investor list and record retention requirements imposed by temporary Treasury regulations on tax shelters. These temporary regulations were issued on February 28, 2000, and amended on August 11, 2000, and August 2, 2001.
- 36.2.2** The engagement partner, principal or tax managing director, or his or her designee, is to submit an Engagement Information Form for each covered engagement at the time an engagement letter is issued and to provide additional information shortly after the signed engagement letter is received from the client. A *covered engagement* generally is any engagement for the provision of tax services that is not on the Exceptions List and for which we reasonably expect to receive fees of \$25,000 or more. The Engagement Information Form and instructions are available on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 36.2.3** The temporary regulations introduce some new terms and are subject to varying degrees of interpretation. The IRS may issue guidance clarifying certain of the provisions of the temporary regulations before the regulations are finalized. Accordingly, the firm intends to gather requisite information for all covered engagements, including those for which a determination may be made not to maintain a list. Firm professionals, therefore, are required to provide engagement information and retain the documents described below, in the manner described below.
- 36.2.4** To the extent the IRS issues additional guidance modifying or clarifying the provisions of the temporary regulations, the policies set forth below will be revised accordingly.
- 36.2.5** The engagement partner, principal or tax managing director, or his or her designee, is to complete an Engagement Information Form for each covered engagement that is subject to the effective dates noted below. More specifically:
- At the time an engagement letter is issued to a client, the responsible tax professional is to complete an Engagement Information Form for the transaction by providing all requested information to the extent known or available at that

May 2002

time. It is expected that not all information necessary to fully complete the form will be known or available at the time the engagement letter is issued, but, at a minimum, the following information will be known or available and, accordingly, is to be provided: client name; name or description of tax solution, idea, or strategy; and engagement partner name and office location.

- Within three business days after submitting the form electronically, the submitter will receive an e-mail from the US-Engagement Information mailbox confirming receipt of the form and assigning a Control Number to the Engagement Information Form. This Control Number will be needed to enter new or revised information concerning the engagement. The e-mail will provide a Web site link for purposes of providing updated information.
- As soon as practicable, but not later than 15 days (or six months for general tax consulting, such as a general tax consulting and compliance engagement, or similar services) after the signed engagement letter is received from the client, the responsible tax professional is to submit the remaining information. If exact information is not available at that time (e.g., the amount of money to be invested), a reasonable approximation should be made and the information later updated if there are material changes.

36.3 Covered Engagements

36.3.1 A *covered engagement* is any engagement for the provision of tax services (alone or in conjunction with other services) that is not on the Exceptions List and for which we reasonably expect to receive fees of \$25,000 or more.

36.3.2 If the engagement letter covers more than one tax solution, idea or strategy, a separate EIF is to be completed for each such solution, idea or strategy, unless otherwise excepted.

36.3.3 A current list (i.e., the “Exceptions List”) of tax engagements that have been determined to be excepted from the definition of covered engagement for this purpose is available on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>. Exceptions include, but are not limited to:

- an engagement letter issued before October 9, 2000, for which no engagement Information Form was required under the provision of TPPL 00-01 that is posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>;
- an engagement that is solely for tax compliance purposes;
- a SALT engagement that does not have the potential effect of reducing or deferring federal income tax; and
- an engagement that solely involves non-income taxes (e.g., gift tax, estate tax, excise tax, customs duty).

36.4 Effective Dates

36.4.1 An Engagement Information Form is to be completed for any covered engagement that satisfies the below effective dates:

- is the subject of an engagement letter signed by a client (corporate or noncorporate) after February 28, 2000; or
- is the subject of an engagement letter signed by a client (corporate or noncorporate) before February 29, 2000, but involving a tax solution, idea or other strategy that the client did not agree to until after February 28, 2000.

36.5 Engagements Without Engagement Letters

36.5.1 Firm policy requires that a signed engagement letter be received for all tax engagements and that a separate signed engagement letter be received for each discrete tax consulting project (with a presumption that any tax consulting project with expected fees in excess of \$20,000 is a discrete project). In linking the effective dates, and certain of the exceptions, to the date the engagement letter is issued or the date the client signs the engagement letter, there is no intent to excuse tax personnel who have not followed firm policy with respect to the issuance of engagement letters and receipt of signed engagement letters from submission of Engagement Information Forms. If any tax services that are not on the Exceptions List have been provided for a fee of \$25,000 or more to a client after February 28, 2000, with respect to which a discrete engagement letter was not issued, or signed engagement letter was not received, an Engagement Information Form with respect to that engagement is to be submitted by the engagement partner, principal or tax managing director, or his or her designee.

36.6 Document Retention

36.6.1 Firm policy requires that correspondence, memoranda and work papers pertaining to an engagement be retained in the client files for that engagement for specified time periods. (Additional guidance is set forth in Chapter 24 of the *RMM—U.S.*) The temporary investor list regulations require that certain documents be retained for tax shelter transactions for which investor lists are required. Engagement professionals are to retain copies of any written materials given to potential participants (or their representatives or agents) in covered engagements subject to the effective dates. These materials include, for example, promotional materials such as *Microsoft PowerPoint™* slides and handouts.

Chapter 37—Foreign Tax Advice and Multi-firm Engagements

37.1 Policies

37.1.1 General

In working with the firm's multinational clients, it is essential that professionals bring the appropriate resources to bear so that the various complexities associated with international tax issues are properly addressed and the high quality of services to our clients is maintained.

37.1.2 Prospective Client Evaluations

In evaluating the underlying client with respect to a request from the originating member firm for U.S. tax advice or the preparation of a U.S. tax return, due consideration is given to the acceptance procedures performed by the member firm. Firm professionals remain responsible, however, for exercising due diligence in determining whether to participate in a client engagement.

37.1.3 Multi-firm Engagement Letters and Inter-firm Instruction Letters

A multi-firm engagement letter and an inter-firm instruction letter are used in all engagements involving member firm participation, in order to clearly define the responsibilities and contractual arrangements of the participating member firms. Both letters generally are initiated by the originating member firm. Typically, the fees to be paid by the client include fees of participating member firms, and the originating member firm makes separate arrangements with the other participating member firms for the payment of fees to those firms.

37.1.4 Coordination and Documentation of Multi-firm Engagements

In making requests to another member firm for foreign tax advice (or the preparation of foreign tax returns) and in responding to requests by a member firm for U.S. tax advice (or the preparation of U.S. tax returns), careful consideration is given to coordinating and documenting the engagement to clearly define the respective rights and responsibilities of the participating member firms. Specific arrangements for the contemplated engagement should be made as early as possible to allow for the proper planning and performance of services requested.

37.1.5 Multi-firm Engagement Files

Multi-firm engagements generally are subject to the tax engagement file requirements set forth in Chapter 33 of this manual.

Each participating office generally is responsible for maintaining appropriate engagement files to support the work performed by that office.

May 2002

	The member firm office leading a multi-firm engagement also is to maintain copies of all final reports and other deliverables provided to it by each participating office pursuant to the engagement, as well as any correspondence or other reports provided directly to the client by those offices.
37.1.6	Dispute Resolution
	While we work with member firms in a cooperative and collegial fashion, professional disagreements occasionally will arise. In the normal course, it is expected that any such disagreements will be resolved by the respective engagement teams.
37.1.7	Legal Services Provided by KPMG Member Firm
	Where a member firm is authorized to provide legal services in its jurisdiction and, in the case of an SEC audit client, where the legal services meet the applicable independence standards, the member firm may provide legal services in connection with the project, provided it is separately engaged by the client.

37.2 General

37.2.1 In working with the firm's multinational clients, professionals bring the appropriate resources to bear so that the various complexities associated with foreign tax issues are properly addressed and the high quality of services to our clients is maintained. Participation of a KPMG International member firm (*member firm*) personnel with relevant foreign tax expertise in client engagements is an effective means of leveraging our global resources to accomplish this objective. Member firm participation also encourages a continual exchange of our collective knowledge to enable us to better serve clients. Additional guidance on multi-firm engagements is set forth in Chapter 23 of the *RMM—U.S.*

37.2.2 There also will be instances where a member firm requests our advice with respect to U.S. tax matters and/or the preparation of U.S. tax returns in servicing its multinational clients. Firm professionals strive to respond to these requests to foster cooperative relationships with other member firms and to further facilitate knowledge sharing.

37.3 Prospective Client Evaluations

37.3.1 In evaluating the underlying client with respect to a request from the originating member firm for U.S. tax advice or the preparation of a U.S. tax return, due consideration is given to the acceptance procedures performed by the member firm. Firm professionals remain responsible, however, for exercising due diligence in determining whether to participate in a client engagement. The extent of the evaluation procedures performed depends on the nature of the engagement.

37.3.2 Where we will provide the requested U.S. tax advice or U.S. tax return directly to the originating member firm and will not report directly to the client or another third party, client evaluation procedures may be limited. However, firm professionals exercise care in evaluating whether special circumstances may exist to warrant a complete evaluation in accordance with firm standards. Firm professionals should remain cognizant of

potential conflict of interest issues that may arise in multi-firm engagements and, in the case of firm audit clients, should consider whether the contemplated scope of services may raise independence issues.

- 37.3.3 Where we will report directly to the client (locally or in the foreign jurisdiction) or to another third party, firm professionals complete client acceptance procedures in accordance with firm standards. Due consideration, however, may be given to the acceptance procedures and findings of the originating member firm. Additional guidance is set forth in Chapter 30 of this manual.

37.4 Multi-firm Engagement Letters and Inter-firm Instruction Letters

- 37.4.1 A multi-firm engagement letter and an inter-firm instruction letter are used in all engagements involving member firm participation, in order to clearly define the responsibilities and contractual arrangements of the participating member firms. Both letters are generally initiated by the originating member firm. Typically, the fees to be paid by the client include fees of participating member firms, and the originating member firm makes separate arrangements with the other participating member firms for the payment of fees to those firms.
- 37.4.2 A sample multi-firm engagement letter and inter-firm instruction letter can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 37.4.3 Where we will be a participating member firm providing U.S. tax advice or U.S. tax returns directly to the originating member firm, in addition to securing an inter-firm instruction letter from the originating member firm, we request a copy of, and review, the engagement letter (including its terms and conditions) that has been or is to be issued to the client by the originating member firm. In reviewing this letter, we consider, for example:
- whether the letter contains limitation of liability and indemnification language that adequately protects the U.S. firm;
 - whether our fees are permissible under the contingent fee rules of the AICPA (Rule 302), the relevant state boards of accountancy and the SEC (for SEC audit clients and affiliates). For example, where a member firm's fees are based on the results of its services and our fees are determined as a percentage of those fees or otherwise by reference to those fees, our fees may be viewed as contingent on the results of our services. In the case of SEC audit clients, the SEC rules would further limit a member firm's fee arrangements when based on results even though our fees may be fixed or based on time and expenses;
 - whether the letter includes confidentiality restrictions with respect to a *client's* information that are overly broad or limit our ability to fulfill our professional responsibilities, or, for engagements that involve federal income taxes, confidentiality restrictions with respect to *KPMG's* information that may raise concerns under the federal confidential tax shelter registration requirements.

May 2002

- 37.4.4 Where a participating member firm is to render tax advice or prepare tax returns to be delivered directly to the originating member firm's client, it generally is preferable that the participating member firm be engaged and paid directly by that client.

Coordination and Documentation of Multi-firm Engagements

37.5 General

- 37.5.1 In making requests to another member firm for foreign tax advice (or the preparation of a foreign tax return) and in responding to requests by a member firm for U.S. tax advice (or the preparation of a U.S. tax return), careful consideration is given to coordinating and documenting the engagement to clearly define the respective rights and responsibilities of the participating member firms. Specific arrangements for the contemplated engagement should be made as early as possible to allow for the proper planning and performance of services requested.

37.6 Foreign Tax Advice

- 37.6.1 We distinguish between advice on foreign taxes that consists of routine tax information (such as withholding rates on interest income) and more specific, complex tax advice and/or the preparation of tax returns.
- 37.6.2 With respect to nonroutine, complex foreign tax advice, we communicate with personnel in other member firms who possess the appropriate technical expertise and experience with the relevant foreign taxes and obtain written confirmation or other documentation of the advice given. Firm professionals contact such member firm personnel at the commencement of the engagement to make arrangements for their advice on the foreign tax matter.
- 37.6.3 Typically, foreign member firm personnel with technical expertise in the relevant foreign taxes will originate the advice. In rare instances, firm professionals may possess sufficient technical expertise to provide the advice. In this instance, it is essential that firm professionals make specific arrangements with foreign member firm personnel with technical expertise in the foreign tax matter to review the advice prior to delivery to the client. Firm policies with respect to review and approval of technical correspondence also apply to advice that incorporates foreign tax matters. Additional guidance is set forth in Chapter 41 of this manual.
- 37.6.4 Where we render advice with foreign tax implications and incorporate facts and/or advice from personnel of a member firm in a foreign country, we clearly state in the documentation of the advice that we are relying on facts and/or advice from the foreign member firm. Depending on the complexity of the advice, firm professionals request that foreign member firm personnel review the final document incorporating their advice to determine that it is appropriate under the circumstances.

- 37.6.5 Written advice that incorporates advice of a member firm in a foreign country should include language similar to the following:

[Add to appropriate section of the letter or memorandum] The following discussion of tax considerations in Country X is based upon advice provided by the KPMG member firm in Country X.

[Add to standard reliance on information/authorities paragraph] Advice relative to tax matters outside the United States is based on tax advice provided by the KPMG member firm in the particular country and on the relevant tax authorities in that country. We also considered U.S. tax treaties, their technical explanations, and judicial and administrative interpretations thereof as appropriate.

37.7 Foreign Tax Returns

- 37.7.1 Where we are requested to prepare foreign tax returns for a client, firm professionals generally communicate with foreign member firm personnel with the appropriate technical expertise and make arrangements for their assistance in preparing the returns. Arrangements should be made with the other member firm early on in the engagement planning process so the returns are completed and delivered to the client in a timely manner.
- 37.7.2 Personnel of a member firm in another country generally will prepare that country's tax returns. In rare circumstances, firm professionals may possess sufficient technical expertise to prepare the returns. In these instances, we make arrangements for the foreign member firm personnel to review the returns prior to delivery to the client.
- 37.7.3 Where it is anticipated that firm professionals will directly prepare foreign tax returns for a client, foreign member firm personnel are consulted to determine whether U.S. personnel preparing the returns may be required to sign the returns as preparers. Where firm personnel are required to comply with certain foreign qualification or licensing requirements in order to sign returns, the arrangement should be structured so that member firm personnel so qualified or licensed will sign the returns.
- 37.7.4 Firm policies with respect to the preparation of U.S. tax returns also generally apply to the preparation of foreign tax returns by U.S. tax personnel. Additional guidance is set forth in Chapter 40 of this manual.

37.8 U.S. Tax Advice

- 37.8.1 Where a foreign member firm requests our assistance in advising that firm or its clients with respect to U.S. tax matters, firm professionals deliver the advice in writing, and it is generally addressed to the member firm personnel requesting the advice (or directly to the client in cases where we are directly engaged by the client). The advice is prepared by firm professionals with the relevant technical expertise, and the standard documentation and review procedures for technical advice are followed. Additional guidance is set forth in Chapter 41 of this manual.

May 2002

- 37.8.2** There may be instances where personnel of a member firm in a foreign country possess sufficient technical expertise to advise on a U.S. tax matter and request that a firm professional provide a technical level review of the advice. The requested review is generally conducted with the same standard of care as if we originated the advice.

37.9 U.S. Tax Advice in a Multiple-party Opinion

- 37.9.1** Where a firm professional renders advice on a U.S. tax matter to be incorporated into a document prepared by a member firm intended for distribution to multiple parties (*i.e., furnished to parties other than the member firm's client, or referenced in a document that also includes an attest report (e.g., report on prospective information), in a document for the sale or exchange of securities, or in a document to be filed with a regulatory agency*), the advice generally is considered a *multiple-party opinion* of the U.S. firm and is subject to the review and approval procedures for such opinions. Additional guidance is set forth in Chapter 41 of this manual.

37.10 U.S. Tax Returns

- 37.10.1** There may be instances where a member firm requests our assistance in preparing U.S. tax returns for its multinational clients. Firm policies with respect to the review and preparation of tax returns apply equally to engagements to review or prepare U.S. tax returns for a client of a member firm. Additional guidance is set forth in Chapter 40 of this manual.
- 37.10.2** A member firm may request that we review U.S. tax returns prepared by the member firm's personnel. Firm professionals exercise care in responding to these requests and carefully consider whether we will be required to sign as preparers of the returns. It is generally anticipated that the member firm will retain primary responsibility for U.S. tax returns that are prepared by its personnel and that those personnel, therefore, will sign the returns. Additional guidance is set forth Chapter 40 of this manual.

37.11 Multi-firm Engagement Files

- 37.11.1** Multi-firm engagements are generally subject to the tax engagement file requirements set forth in Chapter 33 of this manual.
- 37.11.2** Each participating office in a multi-firm engagement is generally responsible for maintaining appropriate engagement files to support the work performed by that office. Such files should, at a minimum, generally include detailed work papers and other documents that appropriately support the advice provided by that office. The participating office should also include in its engagement files copies of all final reports and other deliverables transmitted to the member firm office leading the engagement, as well as any correspondence or other reports provided directly to the client.
- 37.11.3** The member firm office leading a multi-firm engagement also is to maintain copies of all final reports and other deliverables provided to it by each participating office pursuant to the engagement, as well as any correspondence or other reports provided directly to the client by those offices.

37.12 Dispute Resolution

- 37.12.1** While we work with member firms in a cooperative and collegial fashion, professional disagreements occasionally will arise. In the normal case, it is expected that any such disagreements will be resolved by the respective engagement teams. If the dispute cannot be resolved by the engagement teams, the appropriate leaders to whom the engagement teams report should strive to resolve the differences.
- 37.12.2** If satisfactory resolution of a dispute between KPMG—U.S. and another member firm still cannot be reached, the engagement partner should provide full details concerning any unresolved disputes to the vice chairman—tax operations for resolution. The vice chairman—tax operations will work with his counterpart at the member firm to resolve the disputed matter.

37.13 Legal Services Provided by KPMG Member Firms

- 37.13.1** Several member firms provide nontax legal services. In some circumstances, a tax consulting project led by the U.S. firm may require the participation of foreign legal counsel.
- 37.13.2** Where a member firm is authorized to provide legal services in its jurisdiction and, in the case of an SEC audit client, where the legal services meet the applicable independence standards, the member firm may provide legal services in connection with the project, provided the member firm is separately engaged by the client. Generally, a member firm may provide legal services to an SEC audit client (or its affiliates) in connection with the client's (or affiliates) non-U.S. operations when:
- under the laws and regulations of the country in which the legal services are performed, the member firm would be permitted to provide the services to a local public company that engaged another KPMG member firm as its independent auditor;
 - the services relate to matters that are not material to the financial statements or are routine and ministerial; and
 - the services do not involve acting as general counsel, a director or officer, an employee, a member of management, a registrar, a transfer agent, a promoter, an underwriter or a voting trustee in respect of the SEC audit client's (or affiliate's) securities.
- 37.13.3** Detailed guidance regarding independence standards relating to legal services is set forth in Chapter 12 of the *RMM—U.S.*
- 37.14 Working in Other Jurisdictions**
- 37.14.1** Where permitted by local laws or regulations, firm professionals may enter into agreements to perform assignments in a foreign jurisdiction. Further discussion is set forth in Chapter 23 of the *RMM—U.S.*

Part IV—Tax Compliance and Tax Consulting Services

In this Part This part contains six chapters:

Chapter	Title
40	Tax Compliance Engagements
41	Correspondence, Memoranda and Opinions
42	Use of Certain KPMG Professionals in Tax Engagements
43	Loaned Staff and Outsourcing Engagements
44	Tax Personnel Involvement in Accounting Matters
45	Independence Considerations Associated With Tax Services

Chapter 40—Tax Compliance Engagements

40.1 Policies

40.1.1 Standard Tax Compliance Process

The firm's approach to preparing income tax returns is standardized.

A standard tax return docket detailing the compliance services performed, printed from *KPMG/Atlas*, is used for each compliance engagement (including non-income-tax compliance engagements).

40.1.2 Notes to Preparer and Review Notes

Notes to the preparer and tax return review notes are discarded upon completion of the return. Significant data or comments from notes to the preparer are incorporated into the work papers, notes for next year or the permanent file.

40.1.3 Tax Return Review

The tax partner or tax managing director, as applicable, designates the individual (who may be himself or herself, a senior manager, manager, supervising senior or an independent contractor) who has the primary responsibility for the overall substantive accuracy of the return. Such person constitutes the return reviewer. Such person also constitutes the income tax return preparer for purposes of signing the return, however, partners and tax managing directors may sign returns they did not review based on their confidence in the ability of the return reviewer.

Gift and estate tax returns that KPMG prepares or reviews are reviewed by a designated GSTT specialist for generation-skipping transfers and "adequate disclosure" requirements prior to delivery to the client for filing with the Internal Revenue Service.

Trust and estate income tax returns (including Forms 1041, 1041-A, 5227, etc.) that KPMG prepares or reviews are reviewed by a designated GSTT specialist prior to delivery to the client for filing with the Internal Revenue Service.

40.1.4 Tax Return Signature

A list maintained by location of the names and taxpayer identification numbers of all income tax return preparers (including independent contractors) employed or engaged at the location, for each 12-month period ending June 30, is retained.

Firm professionals should make reasonable efforts to determine that tax returns are fully completed and that all relevant information is appropriately disclosed before signing the returns. Professionals may generally rely on information provided by a client without independent verification unless it appears incomplete or incorrect.

May 2002

Firm professionals that are signing preparers of corporate federal income tax returns should make reasonable efforts to ascertain whether transactions reflected on the returns may be reportable under Temp. Treas. Reg. Section 1.6011-4T and should assist clients in their determination as to whether the transactions should be disclosed to the IRS. Signing preparers also should advise clients of the manner of providing disclosure and of the potential accuracy-related penalty consequences of not disclosing. Although there is no explicit penalty for not disclosing under the regulations, the preamble to the regulations suggests that a failure to disclose a reportable transaction may indicate that the taxpayer did not act in good faith for purposes of the reasonable cause and good faith exception to the IRC Section 6662 accuracy-related penalty.

40.1.5 Transmittal Letters and Filing Instructions

We use transmittal letters to convey information to the client about the return and to inform the client of related tax filing obligations and issues. Transmittal letters are prepared for every tax return.

Filing instructions are provided for every tax return and, at a minimum, contain a taxpayer signature reminder, due date for filing returns, address for where to file the returns and amount due or refund.

40.1.6 Return Mailing Address

KPMG addresses are *not* used as the mailing or agent address on a document filed by a client. However, the use of the firm name and address on federal and state extension requests is acceptable, provided that we prepare the extension request and the KPMG address is used only to facilitate the return of the form to us.

40.1.7 Check Signing Engagements

Tax personnel do not accept an engagement involving the signing or countersigning of checks for, or on behalf of, an audit client under any circumstances, nor for a non-audit client without obtaining the express permission of the partner in charge of the Department of Professional Practice—Tax.

40.2 Standard Tax Compliance Processes

- 40.2.1** The firm's approach to preparing income tax returns is standardized. See the Tax Compliance Process Guide for step-by-step instructions on preparing tax returns for compliance engagements. Supporting materials are available on the Engagement Services Practice homepage at <http://taxkm.us.kworld.kpmg.com/homepages/esp/index.htm>.

40.3 KPMG/Atlas

- 40.3.1** Locations maintain a compliance engagement tracking system through the use of *KPMG/Atlas*. Compliance engagements are not limited to income tax returns, but may include gift tax returns, personal property tax returns and so on. Each location

maintains a record of additions to the system and of deletions, changes and roll forwards of items from previous periods.

- 40.3.2** The business unit professional practice partner—tax for the location has oversight responsibility for *KPMG/Atlas*.

40.4 Extension Requests

- 40.4.1** Extension calculations are based on information provided by the taxpayer and are documented in the current year's work papers.

- 40.4.2** If tax is due with the extension request and a check is required to be mailed with the request, the client is provided with the request in sufficient time for the client to make arrangements for payment, and to sign and file the request. KPMG personnel generally do not sign extension requests under these circumstances.

- 40.4.3** If tax is due with the extension request but payment is submitted separately from the extension, written instructions are provided to the client in sufficient time for the client to make arrangements for payment. KPMG personnel who are CPAs, attorneys or enrolled agents may sign the extension request, as preparer, on the client's behalf and mail the request to the tax authority.

- 40.4.4** If no tax is due with an extension, KPMG personnel who are CPAs, attorneys or enrolled agents may sign the extension, as preparer, on the client's behalf and mail the request to the tax authority.

- 40.4.5** A letter (which may be in the form of an electronic mail message or fax) is sent to the client confirming the basis on which the extension calculation was made and (when appropriate) that KPMG signed and mailed the extension.

- 40.4.6** Where KPMG personnel mail an extension request on behalf of a client to the tax authority, the request is sent by registered or certified mail with receipt requested, and a copy of the receipt request and actual receipt are maintained in the client's tax return file. A sample transmittal letter and filing instructions are provided on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

- 40.4.7** For guidance on the use of the firm's mailing address on extension requests, refer to section 40.25 of this chapter.

40.5 Tax Return Docket

- 40.5.1** A standard tax return docket detailing the compliance services performed, printed from *KPMG/Atlas*, is used for each compliance engagement (including non-income-tax compliance engagements).

May 2002

40.6 Notes to Preparer

- 40.6.1** Notes to the preparer are discarded upon completion of the return. Significant data or comments from notes to the preparer are incorporated into the work papers, notes for next year or the permanent file.

40.7 Tax Return Checklists

- 40.7.1** The various AICPA tax return checklists and other checklists that are available on the Engagement Services Practice homepage at <http://taxkm.us.kworld.kpmg.com/homepages/esp/index.htm> are an optional tool to use in connection with the preparation and review of tax returns. Where a checklist is used, with the exception of the *KPMG/Elections* checklist, it is to be considered part of the preparation and review notes, and is to be discarded at the time of the tax return is sent to the client.

40.8 Review Notes

- 40.8.1** Tax return review notes are discarded upon completion of the return. Significant data or comments from the review notes are incorporated into the work papers, notes for next year or the permanent file.

40.9 Election Considerations

- 40.9.1** Although some elections are available annually or subsequently may be changed with the consent of the Commissioner of Internal Revenue (the Commissioner), many elections, once exercised, are irrevocable. Many elections can be made only in a timely filed tax return, by a specified date or within a certain number of days after the promulgation of final regulations.
- 40.9.2** The firm's computer-based electronic elections software, *KPMG/Elections*, is completed and included in the work papers for each compliance engagement. *KPMG/Elections* is located at <http://elections.us.kworld.kpmg.com/Elections/index.asp>.
- 40.9.3** If an election deadline is missed and the relevant statute specifies the time filing requirements, only limited relief is available. However, if the missed deadline is not statutorily imposed, relief usually is available provided the taxpayer acted reasonably and in good faith and granting relief would not prejudice the interests of the government. Policies and guidance for requests for relief from missed elections are set forth in Chapter 62 of this manual.

40.10 List of Tax Return Preparers

- 40.10.1** A list maintained by location of the names and taxpayer identification numbers (Social Security number and/or Preparer Tax Identification Number) of all income tax return preparers (including independent contractors) employed or engaged at the location, for each 12-month period ending June 30, is retained. Such list is retained for at least three years. The term *income tax return preparer* includes any person who prepared or reviewed a substantial portion of any federal tax return, or gave advice directly relevant

to an entry on the tax return. The business unit professional practice partner—tax has oversight responsibility for the retention of this list.

Tax Return Review

40.11 General

- 40.11.1** The tax partner or tax managing director, as applicable, designates the individual (who may be himself or herself, a senior manager, manager, supervising senior or an independent contractor) who has the primary responsibility for the overall substantive accuracy of the return. Such person constitutes the return reviewer. Such person also constitutes the income tax return preparer for purposes of signing the return; however, partners and tax managing directors may sign returns they did not review based on their confidence in the ability of the return reviewer.
- 40.11.2** An independent contractor should be treated as the income tax preparer for purposes of signing the return and extensions only in limited circumstances (e.g., a former KPMG partner or manager who is engaged on a seasonal basis to review tax returns). The approval of the business unit professional practice partner—tax is to be obtained where an independent contractor is to be treated as the income tax preparer for purposes of signing the return.

40.12 Review-only Engagements

- 40.12.1** Clients sometimes ask us to look at tax returns that they have prepared before they are filed (*review-only engagements*). The degree of work we are asked to do varies, from a cursory review of a return that we would not sign as a preparer to a review in which all of the firm's tax return review procedures are performed (e.g., technical review, partner approval for issuance, docket completion, filing instructions preparation, transmittal letter issuance). In most review-only engagements, we will be required to sign as tax return preparer, even though we may do only a limited review.
- 40.12.2** In review-only engagements, our engagement letter clearly describes the limits of our engagement procedures and responsibility, our reliance on the accuracy of client data, and any other matters necessary for the client to understand the degree of our responsibility. A sample review-only engagement letter is available on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 40.12.3** For review-only engagements where we sign as tax return preparer, a copy of the related tax work papers is maintained in our files or the engagement letter provides that the client will permit us access to such tax work papers upon request.

40.13 Gift/Estate Tax Return Review

- 40.13.1** Gift or estate tax returns that KPMG prepares or reviews are reviewed by a designated GSTT specialist for generation-skipping transfers and "adequate disclosure" requirements prior to delivery to the client for filing with the Internal Revenue Service. Gift tax returns reporting only transfers of cash directly to an individual who is not two

May 2002

or more generations younger than the donor (for example, the donor's child or an unrelated individual who is not more than 37 1/2 years younger than the donor) are not subject to this review policy.

40.13.2 Gift and estate tax returns are submitted for review in final or near final form with a list of open points or questions attached. A Form 706 or Form 709 checklist, an adequate disclosure checklist and a trust document review form (if applicable) should be completed for each gift or estate tax return. The adequate disclosure checklist is designed to aid tax professionals in complying with the "adequate disclosure" rules of IRC Section 6501(c)(9). The trust document review form is designed to aid tax professionals with the first-year review of trust documents and is reviewed by the GSTT specialist in the first year (and subsequent years, as necessary) and retained in the permanent file. The permanent files (containing related trust documents, wills, appraisals, deeds of transfer, prior-year gift tax returns and so on) are included with each return submitted for GSTT review. Also, the relationship of each donee/beneficiary to the donor/decedent, and if the donee/beneficiary is not related to the donor/decedent, the donor/decedent's and the donee/beneficiary's dates of birth, are provided to the designated GSTT specialist.

40.13.3 Gift and estate tax returns are received by the designated GSTT specialist no later than 15 calendar days in advance of the tax return filing due date. If the return cannot be delivered to the designated GSTT specialist by the due date for review, the engagement partner or manager makes special arrangements with the designated GSTT specialist. Within each tax return budget, the engagement partner or manager should allocate approximately two hours for GSTT review and approximately one hour for adequate disclosure review. If issues or questions arise, the designated GSTT specialist contacts the engagement partner or manager to discuss the situation before exceeding the combined three-hour budget. The review time is charged to the client contract number provided by the return preparer. The designated GSTT specialist ordinarily will not sign the gift tax return.

40.13.4 Due to the cumulative nature of gift tax returns, the return preparer should retain significant tax work papers that document GSTT planning and allocation in the permanent file.

40.14 Fiduciary Income Tax Return Review

40.14.1 Other than for the exceptions listed below, every trust and estate income tax return (including Forms 1041, 1041-A, 5227, etc.) that KPMG prepares or reviews is reviewed by a designated GSTT specialist prior to delivery to the client for filing with the Internal Revenue Service. Exceptions to this policy are:

- tax returns prepared for real estate investment trusts (REITs), employee benefit trusts (including nonexempt welfare benefit trusts and pension trusts) and trusts which benefit only corporations;
- tax returns prepared at the request of corporate fiduciaries who have expressly waived GSTT review in a signed engagement letter; and

- tax returns prepared at the request of noncorporate fiduciaries who have expressly waived GSTT review in a signed engagement letter and who have affirmed, by executing the engagement letter, that another professional advisor who is knowledgeable in the GSTT area is reviewing the annual GSTT consequences.
- 40.14.2** Trust and estate income tax returns are submitted for review in final or near final form with a list of open points or questions attached. The GSTT checklist and trust document review form (if applicable) should be completed for each fiduciary income tax return. The GSTT checklist is designed to aid tax professionals in reviewing fiduciary income tax returns for GSTT transfers. The trust document review form, designed to aid tax professionals with the first-year review of relevant trust documents, is reviewed by the designated GSTT specialist (in the first year and subsequent years, as necessary) and retained in the permanent file. The permanent files (containing the related trust documents, wills, appraisals, deeds of transfer, prior year estate and gift tax returns and so on), the current work paper file and all relevant prior-year income tax returns filed by the trust or estate are included with each return submitted for review.
- 40.14.3** Fiduciary income tax returns are received by the designated GSTT specialist no later than 15 calendar days in advance of the tax return filing due date. If the return cannot be delivered to the designated GSTT specialist by the due date for review, the engagement partner or manager makes special arrangements with the designated GSTT specialist. Within each tax return budget, the engagement partner or manager should allocate approximately two hours for GSTT review. If issues or questions arise, the designated GSTT specialist contacts the engagement partner or manager to discuss the situation before exceeding the two-hour budget. The review time is charged to the client contract number provided by the return preparer. The designated GSTT specialist ordinarily will not sign the income tax return.
- 40.14.4** As GSTT liability may arise long after a return is prepared, the original signed engagement letters to prepare or review a gift, estate or fiduciary income tax return are to be maintained in the permanent file for the client.
- 40.15 Transfer Pricing Studies**
- 40.15.1** In order for the preparer to sign a tax return with transfer pricing issues without disclosure, he or she must be able to conclude in good faith that the realistic possibility standard has been satisfied as set forth in paragraph 40.18.3 of this chapter. Because documentation is so central to a Section 482 transfer pricing issue, the preparer needs to review the documentation and/or report to determine that the realistic possibility standard is met, regardless of whether KPMG performed the study or did not perform the study.
- 40.15.2** In those situations where KPMG does not perform the transfer pricing study and the client **does not** have contemporaneous documentation, it is recommended that the following precautionary language be included in the transmittal letter:

We have not prepared or participated in the preparation of a "transfer pricing study" for [Client name] for its taxable year ended [date], although

May 2002

we have recommended that you obtain one. We have discussed with you and you have advised us that you understand the requirements of Sections 482 and 6662 of the Internal Revenue Code and the authorities, including Treasury regulations, interpreting those sections. You also have represented to us that the positions on the [year] federal income tax return of [Client name] are in compliance with those requirements.

- 40.15.3** In those situations where KPMG does not perform the transfer pricing study and the client **does** have contemporaneous documentation (i.e., the client or another advisor performed the transfer pricing study), it is recommended that the following precautionary language be included in the transmittal letter:

We have not prepared or participated in the preparation of a "transfer pricing study" for [Client name] for its taxable year ended [date]. You have supplied us with transfer pricing documentation prepared by [you or your advisor], and you have represented to us that the positions contained in such documentation are in compliance with Sections 482 and 6662 of the Internal Revenue Code and the authorities, including Treasury regulations, interpreting those sections.*

- 40.15.4** The use of this precautionary language may significantly reduce the firm's exposure on returns with transfer pricing issues. Significant modifications of this language should be discussed with your business unit professional practice partner—tax.
- 40.15.5** If no transfer pricing study has been performed and the taxpayer is a KPMG assurance client, the tax services partner should inform the assurance engagement partner that a transfer pricing study was not performed so that any potential financial statement effect can be evaluated by the audit team.

Tax Return Signature

40.16 Requirement To Sign Returns

- 40.16.1** An individual is required to sign a federal income tax return or claim for refund as a preparer if the individual prepares all or a "substantial portion" of the return or claim for compensation. A portion of a return or claim generally is considered to be "substantial" if the length and complexity of, and the tax liability or refund involved in, that portion is substantial in relation to the length and complexity of, and tax liability or refund involved in, the return or claim as a whole. There is a penalty of \$50 (maximum \$25,000 in one year) upon an income tax return preparer for failure to sign a return unless it is shown that such failure is due to reasonable cause and not willful neglect.
- 40.16.2** Return *preparation* includes advising on or reviewing return positions, as well as physically completing the return or refund claim, if the advice is directly relevant to the determination of the existence, characterization or amount of an entry on a return or claim. Typing, reproduction or other mechanical assistance by itself does not constitute preparation of a return or claim.

- 40.16.3** If more than one preparer is involved in preparing an income tax return or claim for refund, the individual who is required to sign the return or claim as preparer is the individual who has primary responsibility for the overall substantive accuracy of the return or claim. This excludes personnel of the client who assist in return preparation, even if the client's personnel ultimately are responsible for positions taken on the return or claim. See, in general, Chapter 43 of this manual for a discussion on loaned staff engagements.
- 40.17 Taxpayer Identification Number**
- 40.17.1** Paid tax return preparers who do not wish to disclose their Social Security numbers on federal tax returns they prepare may use a Preparer Tax Identification Number (PTIN) obtained from the Internal Revenue Service instead. The PTIN may be obtained by filing a Form W-7P, *Application for Preparer Tax Identification Number*, with the IRS. The form must be completed by individuals. Therefore, KPMG cannot apply for a PTIN, but a tax preparer who works for KPMG may apply for his or her own PTIN if he or she chooses. A preparer who has obtained a PTIN may use the PTIN for some returns and his or her Social Security number for others. The IRS does not require that the preparer consistently use one or the other.
- 40.18 Standards for Completing Returns**
- 40.18.1** Firm professionals should make reasonable efforts to determine that tax returns are fully completed and that all relevant information is appropriately disclosed before signing the returns. Professionals generally may rely on information provided by a client without independent verification unless it appears incomplete or incorrect. See Treas. Reg. Section 1.6694-1(e); also see Treasury Department Circular 230, Section 10.34(a)(3) and the AICPA's *Statement on Standards for Tax Services No. 2, Answers to Questions on Returns*.
- 40.18.2** A firm professional signing a return must personally believe that any position taken on the return has at least "a realistic possibility of being sustained on its merits" (the realistic possibility standard). A firm professional may, however, sign a return that he or she believes contains a position that does not satisfy the realistic possibility standard if he or she concludes that the position is not "frivolous" (i.e., not patently improper) and it is adequately disclosed. (If the position is contrary to a temporary or final Treasury regulation, a firm professional can sign the return only if the position is disclosed, is not frivolous and represents a good faith challenge to the validity of the regulation.) The preparer should advise the client of penalties reasonably likely to apply with respect to positions taken on the return. A client should also be advised of the opportunity, if any, to avoid penalties by making adequate disclosure of those positions. See Treasury Department Circular 230, Section 10.34(a); also see the AICPA's *Statement on Standards for Tax Services No. 1, Tax Return Positions*.
- 40.18.3** The realistic possibility standard is generally satisfied with respect to a return position if a professional has a good-faith belief that a reasonable and well-informed analysis by a person knowledgeable in the tax law would lead such a person to conclude that the position has approximately at least a one-in-three chance of being sustained on its

May 2002

merits if challenged by the IRS. Thus, the realistic possibility standard does not take into account the possibility of audit or detection by the taxing authority.

The realistic possibility standard is more stringent than the “reasonable basis” standard (Treas. Reg. Section 1.6662-3(b)(3)) but less stringent than the “substantial authority” standard (Treas. Reg. Section 1.6662-4(d)(2)). In determining whether the realistic possibility standard is satisfied, a professional may take into account authorities that are used in determining whether substantial authority is present under IRC Section 6662. A professional should consider the weight of each authority, its relative persuasiveness, relevance and source in arriving at a conclusion as to whether the realistic possibility standard is satisfied. See Treas. Reg. Section 1.6694-2(b); Treasury Department Circular 230, Section 10.34(a)(4)(i) and AICPA Interpretation No. 1-1, “Realistic Possibility Standard” of *Statement on Standards for Tax Services No. 1, Tax Return Positions*. See also TPPL No. 99-13 for a discussion of authorities and their weight.

40.19 Role of Washington National Tax

40.19.1 Firm professionals are to consult with a member of the Tax Controversy Services practice in Washington National Tax, or other appropriate WNT professionals, if there is a question as to whether a firm professional is required to or can sign a return as a preparer, whether the realistic possibility standard is met, the manner of disclosure if disclosure is required and the steps to take if a determination is made that a firm professional cannot sign a tax return under applicable firm and professional standards. Firm professionals should also consult with a member of WNT to resolve questions regarding the presentation of a particular transaction on a return.

40.19.2 Pursuant to review and documentation procedures developed by it, WNT may prescribe the form of presentation for certain specified transactions. Where WNT prescribes the particular form of presentation of a transaction on a return, firm professionals are to follow that form.

40.20 Tax Shelter Disclosure Issues in Preparing and Signing Corporate Returns

40.20.1 Firm professionals that are signing preparers of corporate federal income tax returns should make reasonable efforts to ascertain whether transactions reflected on the returns may be reportable under Temp. Treas. Reg. Section 1.6011-4T and should assist clients in their determination as to whether the transactions should be disclosed to the IRS. Signing preparers also should advise clients of the manner of providing disclosure and of the potential accuracy-related penalty consequences of not disclosing. Although there is no explicit penalty for not disclosing under the regulations, the preamble to the regulations suggests that a failure to disclose a reportable transaction may indicate that the taxpayer did not act in good faith for purposes of the reasonable cause and good faith exception to the IRC Section 6662 accuracy-related penalty. Firm professionals may wish to provide a memorandum regarding the disclosure rules to corporate clients to assist them in complying with the disclosure regulations. A sample memorandum can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

- 40.20.2** Although it is the client's responsibility to decide whether to disclose a transaction under Temp. Treas. Reg. Section 1.6011-4T, a firm professional who is a signing preparer generally should not sign the return as a preparer without a completed disclosure statement, unless he or she believes that a client's decision not to disclose a transaction under the regulations is reasonable. In making this determination, the preparer generally may rely on information provided by a client without independent verification, but should make further inquiries if the information appears incorrect, inconsistent or incomplete. If, however, a transaction has been identified in an IRS notice as a "listed transaction" for purposes of Temp. Treas. Reg. Section 1.6011-4T or is substantially similar to a listed transaction, a taxpayer's decision not to disclose the transaction under the regulations will be presumed to be unreasonable (assuming the projected tax effect test is met). Therefore, a return preparer should not sign a return containing a position for such a transaction without disclosure.
- 40.20.3** Firm professionals are encouraged to consult with their business unit professional practice partner—tax or a member of the Tax Controversy Services practice in resolving questions under Temp. Treas. Reg. Section 1.6011-4T. The responsibility, however, for assisting a client in evaluating disclosure issues under the temporary regulations and in determining whether to sign a tax return without disclosure remains with the firm professional who is the signing or non-signing preparer of the return.
- 40.21 Tax Return Signature Under Power of Attorney**
- 40.21.1** In certain limited circumstances (e.g., nonresident individuals; see Treas. Reg. Section 1.6012-1(a)(5)), a taxpayer may appoint an agent, pursuant to a power of attorney, to file income tax returns on the taxpayer's behalf. We ordinarily do not accept such an appointment due to the potential penalty exposure (accuracy-related penalty under IRC Section 6662 and fraud penalty under IRC Section 6663). These regulations further provide "The taxpayer and agent, if any, are responsible for the return as made and incur liability for the penalties provided for erroneous, false, or fraudulent returns." The approval of the partner in charge of the Department of Professional Practice—Tax is received for any exceptions.
- 40.22 Tax Return Approval**
- 40.22.1** Prior to the start of the engagement, where a tax managing director has not been assigned responsibility for a client, the tax services partner determines the appropriate person to approve release of the tax return to the client. Ordinarily, the partner delegates the approval for the release of a return to a tax manager. However, in certain situations, the tax services engagement partner may decide to retain the responsibility for approval of the release of the return. Where a tax managing director has been assigned responsibility for a client, the tax managing director ordinarily approves release of the tax return to the client. Subject to the approval of the business unit professional practice partner—tax and subject to any conditions that may be set by him or her on that approval, a tax managing director may delegate to a tax manager the authority to approve release of the return.

May 2002

- 40.22.2** When the partner or, where authorized, a tax managing director delegates approval for the release of a return to a manager:
- the delegation is made before the return is completed;
 - a separate delegation is made for each filing period;
 - the manager signs the tax return docket to indicate approval to release the return; and
 - the delegating partner or tax managing director maintains a list to document the delegation to a manager either in the local office or at a compliance center.
- 40.22.3** The list documenting the delegation can simply be a printout of the due date listing from *KPMG/Atlas* for the upcoming year with the manager's initials next to the client's name to indicate the return was delegated to a manager. The list is also disseminated to the management group and to client service support personnel responsible for processing of tax returns. A blanket delegation of all the partner's returns to a manager is not permissible. The partner retains the list for one year, as it will be reviewed during the next QPR Interoffice or Self Review.
- 40.22.4** The tax return for an assurance client is not delivered prior to the delivery of the related audit, review, compilation or other assurance report except for those instances in which client needs necessitate early filing of a return. In such cases, the partner or designee ordinarily documents the reasons for early filing in the tax work papers and considers an appropriate disclaimer in the engagement letter and transmittal letter. A discussion on tax personnel involved in audit engagements is set forth in Chapter 44 of this manual.

40.23 Transmittal Letters

- 40.23.1** We use transmittal letters to convey information to the client about the return and to inform the client of related tax filing obligations and issues.
- 40.23.2** Transmittal letters are prepared for every tax return. The following language is included in each transmittal letter:

These returns were prepared from information provided by you or your representative. The preparation of tax returns does not include the independent verification of information used. Therefore, we recommend you review the returns before signing to ensure there are no omissions or misstatements. If you note anything which may require a change to the returns, please contact us before filing them.

- 40.23.3** When sending extensions and/or estimated payments to a client separate from the tax return, the same standard precautionary language required for tax return transmittal letters is used. The following language is included:

[This/These] [extension application(s) and/or estimated tax payment vouchers] [was/were] prepared from information provided by you or your representative. The preparation of tax returns does not include the independent verification of information used. Therefore, we recommend you review the [extension application (s) and/or estimated tax payment vouchers] before signing to ensure there are no omissions or misstatements. If you note anything which may require a change, please contact us before filing them.

- 40.23.4** Transmittal letters (or filing instructions) inform the client of any estimated tax payment requirements.

- 40.23.5** Special transmittal letter language is used for gift tax returns that include generation-skipping transfers. The generation-skipping transfer tax exemption is applied automatically to any direct skip gifts made during an individual's lifetime unless the individual elects not to have the exemption apply. For these transmittal letters, the following language is suggested:

TIMELY MADE ELECTION

We have discussed with you the generation-skipping transfer tax consequences of the gifts reported on this return and the options available to allocate your exemption to these gifts, to not allocate, or to make a late allocation. You have indicated that you wish to allocate \$[insert amount] of your generation-skipping transfer tax exemption to the [insert Trust] on this gift tax return. The allocation is effective upon filing with the Internal Revenue Service and is based upon the value of the assets at the time of the gift. Once this return is filed, the allocation is irrevocable and may not be changed. [If no allocation is made: It is important you understand that while it may be possible to make an allocation in the future, the tax consequences of doing so may differ significantly from the consequences of making an allocation at this time.]

We recommend that you have this return reviewed by your attorney to determine that it is consistent with your generation-skipping transfer tax, estate tax and gift tax planning. If your attorney notes anything that may require a change, please contact us before filing the return.

or

LATE ALLOCATION

We have discussed with you that this return makes a late allocation of your generation-skipping transfer tax exemption to prior gifts. You have indicated that you wish to allocate \$[insert amount] of your generation-

May 2002

skipping transfer tax exemption to the [insert Trust] on this gift tax return. As a late allocation of your exemption, the allocation is effective upon filing with the Internal Revenue Service and is based upon the value of the assets at that time. Once this return is filed, the allocation is irrevocable and may not be changed.

We recommend that you have this return reviewed by your attorney to determine that it is consistent with your generation-skipping transfer tax, estate tax and gift tax planning. If your attorney notes anything that may require a change, please contact us before filing the return.

- 40.23.6 Special transmittal letter language is used for tax returns with transfer pricing issues where KPMG does not prepare the transfer pricing study. See paragraph 40.15.2 of this chapter for a complete discussion and suggested transmittal letter language.
- 40.23.7 No signature is required on the transmittal letter. Instead, "KPMG LLP" is printed in place of a signature. If desired, the transmittal letter may be signed by the tax services engagement partner, tax managing director or other tax management group member, either in the local office or at a compliance center. In no case is the transmittal letter signed by an independent contractor or by any other person who is not a tax management group member.
- 40.23.8 Transmittal letters are to be marked "Private and confidential." Transmittal letters are not dated, as the date on the tax return represents the transmittal date. The notations "Private and confidential" and "This envelope contains dated material that requires immediate attention" appear on envelopes used to transmit returns to the client.

40.24 Filing Instructions

- 40.24.1 Filing instructions are provided for every tax return and, at a minimum, contain a taxpayer signature reminder, due date for filing returns, address for where to file the returns and amount due or refund. The filing instructions also include the following:

To document the timely filing of your tax return(s), we suggest that you obtain and retain proof of mailing. Proof of mailing can be accomplished by sending the tax return(s) by registered or certified mail (metered by the U.S. Postal Service) or through the use of an IRS approved delivery method provided by an IRS designated private delivery service.

- 40.24.2 Due to variations in proof of mailing rules among states, the reference "or through the use of an IRS approved delivery method provided by an IRS designated private delivery service" should be deleted on state return filing instructions.
- 40.24.3 For clients that may be required to make payments using the Electronic Federal Transfer Payment System (EFTPS), the following paragraph is included if a balance is due:

A deposit in the amount of \$_____ should be made using the deposit method required for your business entity, on or before the due

date noted above. To avoid assessment of a deposit-related penalty, the payment must be made timely and in the required manner, either through the Electronic Federal Tax Payment System or by depositing with a financial institution authorized to receive Federal Tax Deposits (using a completed Form 8109). If you have any questions regarding the electronic funds transfer requirements, we suggest that you contact our office or the Internal Revenue Service before transmitting payment.

40.25 Return Mailing Address

40.25.1 The use of the firm address on tax returns and other filed documents subjects us to unnecessary risks. If we receive official correspondence from the IRS or other governmental authority addressed to a client or former client, our inability to notify the addressee of such correspondence may have serious consequences, particularly if the correspondence requires a timely reply. If a client relationship no longer exists, it may be difficult or impossible for us to determine the present whereabouts or address of the former client.

40.25.2 Accordingly, KPMG addresses are *not* used as the mailing or agent address on a document filed by a client. However, the use of the firm name and address on federal and state extension requests is acceptable, provided that we prepare the extension request and the KPMG address is used only to facilitate the return of the form to us.

40.26 Discovery of Errors in Previously Filed Returns

40.26.1 In the course of preparing or reviewing tax returns, we may discover errors in previously filed returns. The AICPA's *Statement on Standards for Tax Services No. 6* provides that:

The CPA should inform the client promptly upon becoming aware of an error in a previously filed return or upon becoming aware of a client's failure to file a required return.

40.26.2 Treasury Department Circular 230 similarly requires that the client be advised of the error.

40.26.3 We document that we advised the client of the error and of appropriate measures to take. The documentation is in the form of a copy of the written communication to the client or, if the advice was oral, a contemporaneous memorandum to the file.

40.26.4 Although we ordinarily recommend the appropriate measures to take, the client is responsible for correcting the error. If the client does not correct an error, we consider whether to continue our professional relationship with the client. The significance, timing and other judgment determinations of the error may affect our decision.

40.26.5 If we learn that the client is using an erroneous method of accounting and the due date for filing a request for a change in method has passed, we still may sign the return for the current year, provided the return includes appropriate disclosure of the use of the erroneous method.

May 2002

40.27 Claims for Refund

- 40.27.1** We consider and inform our clients of the possible consequences of filing a claim for refund. For example, filing a refund claim or an amended return to claim a refund may cause an examination of the tax return to which it relates.
- 40.27.2** Actual and potential claims for refund are monitored using *KPMG/Atlas*.
- 40.27.3** If it appears that an examination might result in sufficient adjustments to offset the claim for refund and create a potential tax deficiency, in certain circumstances, we may advise a client to defer filing a refund claim until just prior to the tolling of the statute of limitations for a tax deficiency. In this manner, the tax effect of adjustments is limited to an offset of the tax refund claimed.
- 40.27.4** A claim for refund forms a basis for a suit for refund. It is important that all alternative theories supportive of the claim are raised by the claim before the expiration of the statute of limitations and that the claim is sufficiently precise to reasonably apprise the applicable tax authority of the exact nature of the basis for the claimed refund.
- 40.27.5** The amount of the claimed refund may significantly affect the refundable amount in a suit for refund. For this reason, it is desirable to footnote the amount of tax refund claimed with the legend "or such greater amount as may be properly refundable together with interest as provided by law" to allow for uncertainties created by other provisions, such as the carryback rules.

40.28 Check Signing Engagements

- 40.28.1** Tax personnel accept no engagements that involve signing or countersigning of checks for or on behalf of an audit client under any circumstances, nor for a non-audit client unless the express permission of the partner in charge of the Department of Professional Practice—Tax is obtained prior to accepting the engagement.
- 40.28.2** The above described policy applies equally to any engagement where payment of client bills is made electronically or is made through disbursement from a KPMG account (irrespective of whether reimbursement from the client is received prior or subsequent to the reimbursement). Occasional disbursements from a KPMG account on behalf of a non-audit client are excepted from this policy if the disbursement is for less than \$2,000 and is made only where alternative arrangements are impracticable. Any disbursement from a KPMG account on behalf of an audit client or for \$2,000 or more on behalf of a non-audit client is permissible only if advance approval of the business unit tax professional practice partner—tax is obtained.
- 40.28.3** Bill-paying services may be provided to high net worth individual clients provided all of the following requirements are met:
- the services are considered to be both strategic and profitable and there is a business case which is preapproved by the vice chairman—tax services;
 - checks may only be signed by partners;

- checks in excess of \$25,000 require the dual signatures of partners;
- an indemnification letter is signed by the client in advance of agreeing to such engagements. A sample indemnification letter is posted on the Department of Professional Practice—Tax homepage. Any revisions to the language in the attachment require the approval of the Office of General Counsel;
- the engagement letter for the service is approved in advance by the Department of Professional Practice—Tax;
- all bills that are paid for clients are paid only after the client directs us in writing to pay the bill. In other words, we do not make the decision as to whether or not the bill is paid, how much is paid, and so forth;
- the client is not in a position of significant influence over an SEC audit client or otherwise associated with such a client in a decision-making capacity, such as an officer, a director or a substantial shareholder.

Chapter 41—Correspondence, Memoranda and Opinions

41.1 Policies

41.1.1 Correspondence

Technical advice is documented in writing and maintained in the appropriate tax file.

Technical tax correspondence and memoranda are reviewed, prior to issuance, by a tax services partner, tax managing director, principal, or manager, other than the preparer. If the reviewer is a manager, the material is approved, prior to issuance, by a tax services partner or principal.

If tax services personnel receive tax advice from a national specialist, a copy of the related documentation is forwarded to the specialist. If a national specialist gives tax advice directly to a client, the specialist forwards a copy of the related documentation to the tax services engagement partner or tax managing director, if different.

We copy our clients on correspondence sent to third parties, such as the Internal Revenue Service.

The assurance engagement partner is copied on tax correspondence relating to an assurance services client.

Technical tax correspondence, such as research memoranda, letters of advice, opinion letters, requests for rulings and protests, cites the authorities upon which it relies.

Technical tax correspondence is sent electronically to the Outlook address, Tax Knowledge Inbox, for knowledge-sharing purposes.

41.1.2 Memoranda

In researching a particular tax issue, it is desirable to prepare a memorandum covering such research that includes a statement of facts, issues, conclusions, citations and authorities.

We maintain a record of significant oral advice. We document such advice either in a confirming letter to the client or in a memorandum to the files.

41.1.3 Letters of Advice and Opinions

Letters and memoranda of tax advice and tax opinion letters state in a clear, complete and concise manner the material or relevant facts upon which the conclusions are based and demonstrate adequate support for the conclusions reached, including, where appropriate, documentation such as citations and attachments of research. Such documents also include appropriate precautionary language.

May 2002

Firm policies for accepting and performing a multiple-party engagement apply to the undertaking of such an engagement and the preparation, review, and approval of a multiple-party opinion.

A tax opinion directly on an accuracy-related penalty and a multiple-party tax opinion are to be approved by the partner in charge of the Department of Professional Practice—Tax *prior to committing* to the client to issue the opinion.

Certain tax opinions are approved by Washington National Tax partner(s) or principal(s) for the technical issue(s) *before the opinion is issued* to the client or another party.

A tax opinion on the temporary tax shelter regulations relating to disclosure of "reportable transactions" (Temp. Treas. Reg. Section 1.6011-4T), registration of tax shelters (Temp. Treas. Reg. Section 301.6111-2T) and maintenance of investor lists (Temp. Treas. Reg. Section 301.6112-1T) is to receive *precommitment and preissuance* approval by the WNT Tax Controversy Services group. We generally do not issue opinions on tax shelter registration or investor list requirements.

Correspondence

41.2 General

- 41.2.1 Some correspondence is subject to policies and guidance in addition to those discussed in this section. For example, additional guidance regarding requests for IRS rulings (including protests), tax returns and transmittal letters, and tax advice provided to and from KPMG member firms are set forth in Chapters 60, 40 and 37 of this manual, respectively.

41.3 Signatures

- 41.3.1 Generally, correspondence is signed personally only by a partner, principal, director, tax managing director, senior manager or manager as dictated by the nature and content of the communication. Reports and correspondence that only partners and principals are authorized to sign are as follows:

- multiple-party opinions; and
- correspondence signed in the firm name.

Specific policies and related guidance with respect to the signing of communications are set forth in Chapter 22 of the *RMM—U.S.*

41.4 Transmission

- 41.4.1 Correspondence and envelopes are marked "Private and confidential" if the material warrants such a designation.

- 41.4.2** When sending correspondence by facsimile (fax), the KPMG fax template is used. If private material is faxed, the sender informs the addressee that the material is being sent. When correspondence is sent by electronic mail over the Internet, the sender considers whether it is appropriate to use the Internet as the delivery medium considering the nature of the information being communicated.

41.5 Documentation

- 41.5.1** Correspondence and memoranda are typed using the KIS standard template in *Microsoft WordTM*.
- 41.5.2** Electronic transmissions, such as facsimiles, electronic mail and mail within a computer network, are correspondence subject to the same preparation, review, approval and retention policies that apply to other technical tax correspondence.
- 41.5.3** A copy of the technical advice, documented as memoranda, letters or memoranda of oral advice, is maintained in the appropriate tax file.
- 41.5.4** Review of tax correspondence is documented in writing. See paragraph 41.6.8 below.
- 41.6 Review**
- 41.6.1** We review technical tax correspondence to safeguard technical accuracy. Technical advice is documented as memoranda, letters or memoranda of oral advice to facilitate a review of the advice.
- 41.6.2** Technical tax correspondence and memoranda are reviewed, prior to issuance, by a tax services partner, principal, tax managing director or manager other than the preparer. If the reviewer is a manager, the material is approved, prior to issuance, by a tax services partner, principal or, with respect to day-to-day consulting matters, tax managing director. It is important that the preparer and the reviewer of a technical tax letter or memorandum be conversant with the facts and technical aspects of the case. Such personnel also verify that the conclusions reached are supported by the authorities cited.
- 41.6.3** If divergent opinions or other conflicts arise between the preparer and the reviewer of technical tax correspondence and cannot otherwise be resolved, the appropriate national specialist is contacted to resolve the disagreement.
- 41.6.4** These policies apply whether technical correspondence is written in English or in a foreign language. Special care may be needed to select a reviewer who is conversant in both the technical issues addressed and in the foreign language used in the document.
- 41.6.5** Ordinarily, the professional giving the advice documents it and obtains the necessary review and approvals. In the case of advice given by national specialists, such as WNT personnel, to other tax services personnel, the professional receiving the advice is responsible for its documentation, obtaining review and approval. In addition to the required routing discussed in this section, the national specialist receives a copy of the documentation.

May 2002

- 41.6.6 If a national specialist gives advice directly to a client, the specialist documents the advice and obtains the necessary review and approvals. If the national specialist is not the tax services engagement partner or tax managing director, the tax services engagement partner receives a copy of the documentation.
- 41.6.7 Nontechnical correspondence addressing resolution of client specific factual matters or transmitting client specific information is reviewed prior to issuance. The preparer or reviewer of such correspondence is a tax services partner, principal, tax managing director or manager.
- 41.6.8 Review of tax correspondence is documented in writing. It is recommended that the completed TKS submission template be printed, attached to the file copy of the correspondence, initialed by the preparer, initialed by the reviewer and, for technical correspondence, initialed by a partner, principal or tax managing director if neither the preparer nor the reviewer is a partner, principal or tax managing director. The TKS submission template is available in the Tax Knowledge Sharing Info public folder in Outlook. At the option of the local office, documentation of the review process may be accomplished in an alternative manner, such as use of a rubber approval stamp or a KIS template approval stamp. If an alternative documentation procedure is used, it is to include a line to indicate whether the document was submitted to the Tax Knowledge Inbox.
- 41.6.9 If correspondence does not address technical issues or client-specific factual matters, no review is necessary.
- 41.6.10 We copy our clients on correspondence sent to third parties, such as the Internal Revenue Service.
- 41.6.11 The assurance engagement partner is copied on tax correspondence relating to an assurance services client.
- 41.7 **Alternative Review**
 - 41.7.1 If tax services are provided in a location in which there is only one tax services partner or manager, in which no partner or manager with the appropriate technical experience is available, or in which the only person available to review the correspondence is the one who originated it, the review may be performed by qualified personnel in another location. It is important that firm personnel recognize their responsibility to promptly perform this review service for other locations.
- 41.8 **Draft Documents**
 - 41.8.1 Usually, firm personnel refrain from sending draft documents to a client as the client may commence a course of action based on the draft document, or because the draft document may never be finalized. In limited circumstances, it may be appropriate to send a client a draft document to confirm the facts of an issue or to verify that the client's issues are being properly addressed. If necessary, the draft document is reviewed, prior to issuance, according to our standard correspondence procedures in section 41.6 of this chapter. In addition, each page of the document is clearly marked

“DRAFT: For discussion purposes only.” Once the final version of the document is complete, all draft versions of the document, both electronic and printed, are destroyed, and the document, at that point only, is submitted to TKS.

41.9 Citations

- 41.9.1** Technical tax correspondence, such as research memoranda, letters of advice, opinion letters, requests for rulings and protests, cites the authorities upon which it relies. A citations guide that may be used to cite to tax-related authorities appears in Appendix B.

41.10 Tax Knowledge Inbox

- 41.10.1** Technical tax correspondence is promptly sent to the Outlook address, Tax Knowledge Inbox, for knowledge-sharing purposes. The electronic submissions are routed to a team of specialists in the relevant subject area, generally headed by a manager in Washington National Tax, for review. The primary purpose of that review is to determine if the correspondence is worthy of knowledge sharing and/or further idea development. If there appears to be a significant technical error or errors in the correspondence, the originator will be contacted. However, the primary purpose of the review is not to verify the technical accuracy of the correspondence. It is incumbent on the originator to consult with national technical resources, as appropriate, *before* issuing the correspondence. Once a document is reviewed in accordance with section 41.6 of this chapter, the message is sent to the Tax Knowledge Inbox after the TKS Submission Template is completed and the document file is attached. The TKS Submission Template and other related documents are available on the Tax Knowledge Management homepage at <http://taxkm.us.kworld.kpmg.com/homepages/Tkm/Index.htm>.

41.10.2 Materials sent to the Tax Knowledge Inbox include:

- tax correspondence with technical content;
- tax memoranda, including memoranda of oral advice;
- protests filed with the appropriate IRS directors;
- spreadsheets provided for a client's use;
- client presentations;
- requests for rulings, determination letters or information letters addressed to the appropriate IRS directors and their replies;
- Private Letter Rulings;
- speech outlines;
- articles for external publication;

May 2002

- comment letters to governmental agencies (does not include responses to governmental agencies with respect to routine client matters);
- reports; and
- proposals.

41.10.3 Material that should **not** be sent to the Tax Knowledge Inbox include:

- documents subject to attorney-client privilege;
- documents prepared under a confidentiality agreement which restricts access to the engagement team;
- client engagement letters;
- tax provision review memoranda provided for assurance clients;
- tax return transmittal letters;
- extension requests;
- correspondence in the form of an unmodified suggested client letter originating in Washington National Tax or the Tax Innovation Center; and
- spreadsheets created solely for KPMG work papers, although you are encouraged to submit spreadsheets which could have value for other engagement teams.

41.10.4 The following procedures are designed to facilitate the submission of both hard copy and electronic copy items to the Tax Knowledge Inbox. Ultimate responsibility for the adherence with the documentation and review procedures rests with the preparer and reviewer of the correspondence.

- In the case of hard-copy correspondence, simultaneous with the preparer's request for review, a copy of the correspondence and review request is forwarded to the preparer's administrative assistant who then prepares a TKS Submission Template. The administrative assistant obtains documentation of the preparer and reviewer's approval of the correspondence on the TKS Submission Template and forwards a copy of the completed template and correspondence to the Tax Knowledge Inbox and a signed-off copy of the TKS Submission Template and the correspondence are placed in the correspondence file. The preparer and reviewer of the correspondence have responsibility for verifying adherence with the documentation and review procedures applicable to correspondence.
- For correspondence in the form of e-mail, the preparer first forwards a copy of the proposed e-mail to the reviewer for approval. Upon receipt of approval, the preparer may then send the e-mail to the client, with a copy to the reviewer and a blind copy to the preparer's administrative assistant. The administrative assistant then prepares the TKS Submission Template and obtains documentation of the

preparer and reviewer's approval of the correspondence and forwards a copy of the completed template e-mail to the Tax Knowledge Inbox and a signed-off copy of the TKS Submission Template and printed copy of the e-mail are placed in the correspondence file. The preparer and reviewer of the correspondence have responsibility for verifying adherence with the documentation and review procedures applicable to correspondence.

Memoranda

41.11 General

- 41.11.1** The review policies for technical tax correspondence apply to both formal memoranda pertaining to research of a particular problem or set of circumstances and to internal memoranda documenting telephone or other oral advice given to clients.

41.12 Research Memoranda

- 41.12.1** In researching a particular tax issue, it is desirable to prepare a memorandum covering such research that includes a statement of facts, issues, conclusions citations and authorities. In those instances in which we provide advice and do not send a letter of advice or opinion letter to the client, we consider sending a copy of the memorandum to the client with a transmittal letter. If the memorandum is sent to the client, it contains appropriate precautionary language (refer to section 41.20 of this chapter). Whether the research memorandum is retained in the files only or sent to the client, the review policies for technical tax correspondence apply.

- 41.12.2** A research memorandum contains a brief title, a complete statement of the facts, a concise statement of the issues presented, conclusions reached that are expressed as opinions, and the arguments and authorities upon which the conclusions are based.

41.13 Memoranda of Oral Advice

- 41.13.1** We maintain a record of significant oral advice. We document such advice either in a confirming letter to the client or in a memorandum to the files.
- 41.13.2** A confirming letter ordinarily is sent to the client with respect to oral advice that might influence the client in some future course of action or that might prompt the client to refrain from action that otherwise would be taken. If circumstances prevent us from issuing a letter, a memorandum to the files is prepared and the reason for not sending a confirmation letter is noted in the files.
- 41.13.3** Whether a memorandum to the files or a confirming letter of advice is prepared to document the oral advice, this documentation is subject to the same preparation, review and approval policies that apply to other technical tax correspondence. The KIS standard template available in *Microsoft Word™* is used for memoranda of oral advice.

May 2002

Letters of Advice and Opinion Letters**41.14 General**

41.14.1 Our letters of advice and opinion letters may assist a client to decide whether to consummate a transaction, restructure the manner or method of a proposed course of action or abandon a contemplated transaction or course of action. Significant oral advice, particularly that relating to prospective transactions, is to be confirmed with the client in writing. Refer to section 41.13 of this chapter for further discussion of memoranda of oral advice.

41.14.2 Letters and memoranda of tax advice and tax opinion letters shall state in a clear, complete and concise manner the material or relevant facts upon which the conclusions are based and shall demonstrate adequate support for the conclusions reached, including, where appropriate, documentation such as citations and attachments of research. For further guidance, an opinion template is located on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

41.15 Definition of Opinion

41.15.1 A *tax opinion* is any written advice on the tax consequences of a particular issue, transaction or series of transactions that is based upon specific facts and/or representations of the client and that is furnished to the client or another party in a letter, a whitepaper, a memorandum, an electronic or facsimile communication, or other form.

41.16 Opinions Requiring Precommitment Approval by the Partner in Charge of the Department of Professional Practice—Tax

41.16.1 The following tax opinions described below are to be approved by the partner in charge of the Department of Professional Practice—Tax *prior to committing* to the client to issue the opinion:

- an opinion directly on an accuracy-related penalty (i.e., if the position is disallowed, it is at least more likely than not that an accuracy-related penalty will not apply to the tax underpayment);
- a multiple-party tax opinion as defined in paragraph 41.22.1 of this chapter.

41.17 Opinions Requiring Preissuance WNT Approval

41.17.1 All tax opinions described below are to be approved by the appropriate WNT partner(s) or principal(s) for the technical issue(s) *before the opinion is issued* to the client or another party.

- any “prototype” tax opinion for a tax solution or strategy developed in conjunction with the Tax Innovation Center;

- any tax opinion that relates to a transaction where KPMG's fees exceed \$1 million (directly or as a result of a reasonable allocation of fees in a larger engagement, such as a Stratecon engagement);
- any "should" or "will" opinion, even if related to a transaction with fees of \$1 million or less, if the potential tax benefit to the client over time (i.e., not on a present value basis) reasonably is expected to exceed \$5 million. For this purpose, a "should" opinion includes a "more-likely-than-not" opinion issued to a client where the tax team intends to communicate to the audit team that a "should" opinion could be issued on the transaction, in order that financial statement benefits might be claimed for the transaction;
- an opinion directly on an accuracy-related penalty (i.e., if the position is disallowed, it is at least more likely than not that an accuracy-related penalty will not apply to the tax underpayment);
- a multiple-party tax opinion as defined in paragraph 41.22.1 of this chapter; and
- an opinion for a tax solution or strategy where the *Tax Solution Alert* or other solution notification document specifies such an approval requirement.

41.18 Opinions Requiring Precommitment and Preissuance Approval by the WNT Tax Controversy Services Group

41.18.1 The following tax opinions described below are to be approved by the WNT Tax Controversy Services group prior to committing to the client to issue the opinion and prior to issuing the opinion to a client or another party:

- an opinion on the temporary tax shelter regulations relating to disclosure of "reportable transactions" (Temp. Treas. Reg. Section 1.6011-4T), registration of tax shelters (Temp. Treas. Reg. Section 301.6111-2T) and maintenance of investor lists (Temp. Treas. Reg. Section 301.6111-1T). It is anticipated that an opinion on the disclosure regulations generally will be limited to whether we believe the client would have a position not to disclose (rather than opining that the transaction is or is not disclosable). Firm professionals generally should not give an opinion on the registration or investor list requirements.

41.18.2 Firm professionals are encouraged to consult with their local/area Tax Controversy Services professional concerning corporate tax shelter issues and to involve the local/area Tax Controversy Services professional in the drafting of opinions.

41.19 Levels of Opinion

41.19.1 Caution is to be exercised when issuing a *will* opinion. Will opinions provide significantly greater levels of assurance to a client on a tax position than is necessary to avoid the accuracy-related penalty, at additional risk to the firm. The relevant standards are described briefly below:

May 2002

Will: Generally, a 95 percent or greater probability of success if challenged by the IRS. A will opinion generally represents the highest level of assurance that can be provided by an opinion.

Should: Generally, a 70 percent or greater probability of success if challenged by the IRS. A should opinion provides a lower level of assurance than a will opinion, but a higher level of assurance than is provided by a more-likely-than-not opinion.

More-likely-than-not: A greater than 50 percent probability of success if challenged by the IRS. The more-likely-than-not standard is the highest level of accuracy required for purposes of the accuracy-related penalty.

Substantial authority: Usually, greater than a realistic possibility of success and lower than more-likely-than-not.

Realistic possibility of success: A one-in-three possibility of success if challenged by the IRS.

Reasonable basis: Significantly higher than not frivolous (that is, not patently improper) and lower than realistic possibility of success. The position must be reasonable based on at least one tax authority.

- 41.19.2 See Tax Professional Practice Letters 99-13 and 00-05 for more information regarding opinions.

41.20 Precautionary Language

- 41.20.1 The client is informed that our advice reflects professional judgment based on an existing situation or assumed facts and that subsequent developments could affect previously given professional advice. At a minimum, the following precautionary language paragraph is used:

Our advice in this letter is based on the facts as stated and on authorities that are subject to change, retroactively and/or prospectively.

This puts the client on notice and helps protect the firm if the writer was not apprised of all the relevant facts or if the facts or law changes after we issue the letter. Both circumstances could affect our conclusion. Such a statement about the scope of the facts upon which our conclusion is based is particularly important if the request for advice was received orally.

- 41.20.2 Often, the nature of our advice and the client's facts and circumstances are such that the minimum required language does not adequately convey the importance of our reliance on stated facts, assumptions and representations or the limits of our advice. In order to fully inform the client and to better protect the firm, it often is appropriate to use the following more substantial precautionary language paragraphs:

The opinions contained in this letter are based on the facts, assumptions and representations stated herein. You represented to us that you have provided us with all facts and circumstances that you know or have reason to know are pertinent to this opinion letter. If any of these facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately in writing as the incompleteness or inaccuracy could cause us to change our opinions.

Our advice in this opinion letter is limited to the conclusions specifically set forth herein under the heading Opinions. KPMG expresses no opinion with respect to any other federal, state, local, or foreign tax or legal aspect of the transactions described herein. No inference should be drawn on any matter not specifically opined on above.

In rendering our opinions, we are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended [or, if applicable, state and local tax statutes], the regulations thereunder, and judicial and administrative interpretations thereof—all as in effect on the date of this letter. These authorities are subject to change or modification retroactively and/or prospectively and any such changes could affect the validity or correctness of our opinion. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof, unless you separately engage us to do so in writing after such subsequent change or modification.

These opinions are not binding on the Internal Revenue Service, any other tax authority, or any court, and no assurance can be given that a position contrary to that expressed herein will not be asserted by a tax authority and ultimately sustained by a court.

41.20.3 Precautionary language that is included in broadly distributed mailings, such as newsletters, booklets and brochures, is discussed in Chapter 23 of this manual.

41.21 Other Considerations

41.21.1 Letters of advice and opinion letters may be addressed to the client, to an officer or employee of a corporate client, to the managing partner of a partnership client, to a trustee of a trust that is a client, or to legal counsel of a client if the client's counsel has requested our advice. Such letters ordinarily are not addressed to all the partners of a partnership or to all the stockholders of a corporation since some of them might not be our clients.

41.21.2 Unless the requirements for a multiple-party opinion, as discussed in section 41.22 of this chapter, are met, our letters of advice and opinion letters may not be reproduced, included, or referred to in any document or other material provided to other parties.

May 2002

41.22 Multiple-party Opinions

- 41.22.1** A *multiple-party opinion* is a written tax opinion that reasonably may be expected to be furnished to parties other than the client who pays for the opinion, or referenced in a document that also includes an audit report (e.g., report on prospective information), in a document for the sale or exchange of securities, or in a document to be filed with the SEC or other regulatory agency. The opinion may be with respect to a particular issue, a transaction or a series of transactions. If the opinion is intended to be furnished to only one other party in addition to the client and that party is clearly identified in the engagement letter, the opinion is not a multiple-party opinion (provided it is not referenced in a document that includes an audit report, in a document for the sale or exchange of securities, or in a document filed with a regulatory agency). An opinion provided to a pass-through entity (such as a partnership or S corporation) is not a multiple-party opinion simply because tax attributes of the entity will be reflected on tax returns of its investors; however, if a copy of the opinion is intended to be provided to multiple partners or shareholders who are not signatories to the engagement letter, it is a multiple-party opinion. An opinion provided to a corporation concerning a corporate tax matter is not a multiple-party opinion merely because a copy may be forwarded to the board of directors or parent or subsidiary corporations.
- 41.22.2** The partner in charge of the Department of Professional Practice—Tax is required to approve the engagement before the firm makes a commitment to the client to issue a multiple-party opinion. The request for approval addresses each of the matters specified below, includes a draft of the engagement letter and describes the document, if any, in which the opinion is to be included.
- 41.22.3** The following matters are addressed in the request for approval to issue a multiple party opinion:
- the name of the client to whom the opinion would be issued and a summary of the issue, transaction or series of transactions on which the opinion would be issued;
 - the length of time the client has been a tax client;
 - the name of the partner in WNT, or other partner authorized by the partner in charge of the Department of Professional Practice—Tax, who will review and approve the opinion prior to issuance;
 - the expected opinion to be provided, including the expected “level” (e.g., “more likely than not,” “should,” or “will”). As a general matter, approval will not be given if we are unable to provide at least a “should” level of opinion;
 - whether the client is an audit client and, if so, the identification of the engagement partner—audit;
 - if the opinion is to be used by the client to promote the sale of its products or services, sufficient information on the client and its principals so that a background check may be conducted, if appropriate;

- a copy of the proposed engagement letter which clearly defines the scope of the engagement and the use to be made of the opinion and specifies a fee that is expected to result in at least 150 percent realization on the engagement. The minimum acceptable fee for a multiple-party opinion ordinarily is \$25,000 (\$50,000, if the opinion is intended to be used by the client to promote the sale of its own products or services); and
 - if the opinion is to be included or referenced in an offering document for the sale or exchange of securities, the name of the SEC partner who will review the document for adherence to the firm policies set forth in the *SEC Manual*.
- 41.22.4** Approval by the partner in charge of the Department of Professional Practice—Tax of a request to issue a multiple-party opinion will be conditioned on:
- receipt of an acceptable signed engagement letter;
 - receipt of a representation letter from the client setting forth the facts and representations upon which we will be relying in issuing our opinion;
 - preissuance approval of the opinion by the designated WNT or other authorized partner;
 - in the case of an audit client, preissuance review by the audit partner of the facts and representations contained in the opinion; and
 - where the opinion is included or referenced in a document for the sale of securities, preissuance approval by the designated SEC partner.
- 41.22.5** Multiple-party opinions are required to include precautionary language substantially similar to the precautionary language set forth in paragraph 41.20.2 of this chapter.

Chapter 42—Use of Certain KPMG Professionals in Tax Engagements

42.1	Policies
42.1.1	General
	KPMG tax personnel determine that the technical resources of the firm are utilized appropriately in the delivery of tax services to clients.
42.1.2	Involvement of Compensation and Benefits in Golden Parachute Engagements
	Designated Compensation and Benefits professionals are to be involved in and responsible for the direction of Golden Parachute services performed by KPMG for the employer.
42.1.3	Involvement of Tax Controversy Services in Delivery of Federal Tax Strategies
	Firm personnel are required to involve a Tax Controversy Services professional in the review of the appropriateness of documentation involved in the delivery of federal tax strategies where KPMG's fees are expected to exceed \$250,000.
42.1.4	Involvement of Export Tax Management in Extraterritorial Income Exclusion Engagements
	Firm personnel are required to involve a designated Export Tax Management specialist in the preparation or review of the relevant portion of U.S. corporate, partnership and individual tax returns that include income in excess of \$2 million earned from sales, leases or licenses to customers outside the U.S. for the tax periods ending after September 30, 2000.
42.1.5	Involvement of Economic Downturn Tax Consulting Services in Bankruptcy Engagements
	Prior to initiating proposal efforts for or entering into a tax engagement with a prospective or current KPMG client who is contemplating or involved in a bankruptcy proceeding or out-of-court restructuring, tax professionals are to contact one of the members of the Economic Downturn Tax Consulting Practice team.
42.1.6	Involvement of International Corporate Services Personnel in International Corporate Tax Consulting and Compliance Engagements
	International Corporate Services (ICS) personnel should be involved in international corporate tax consulting and compliance engagements.

May 2002

42.1.7 Involvement of Investment Advisory Services

Most firm personnel are not investment advisors and do not render investment advice. Investment advisory services may be offered only by personnel specifically authorized to provide these services by the investment advisory committee of KPMG Investment Advisors.

42.1.8 Involvement of GSTT Specialist in the Review of Gift Tax, Estate Tax, and Fiduciary Income Tax Returns

Gift tax, estate tax, and fiduciary income tax returns that KPMG prepares or reviews are reviewed by a designated GSTT specialist prior to delivery to the client for filing with the Internal Revenue Service. Detailed guidance is set forth in Chapter 40 of this manual.

42.2 General

42.2.1 In the delivery of tax services to clients, KPMG tax personnel determine that the technical resources of the firm are utilized appropriately. While determination of the appropriate use of a technical specialist in a particular situation necessarily is a matter of judgment, our emphasis is on consistently providing high quality value-added services to our clients. As the provision of value-added services usually involves a specialized area of tax law, the involvement of a national or area technical tax specialist is usually to be expected. The following nonexclusive examples are illustrative of this general principle:

- economic consulting services personnel and/or an international tax services partner or manager usually are to be involved in any engagement involving advice relating to cross-border intercompany transfer pricing;
- a *tax reduction* (*Stratecon*, *Strategic Business Solutions* and so on) engagement is to be led by an individual with the requisite training in the particular tax reduction service;
- members of the Subchapter C group in Washington National Tax, or other national tax resources with significant Subchapter C experience, usually are to be consulted on issues relating to corporate acquisitions and dispositions. In the case of a major acquisition or disposition, direct involvement in the transaction by a member of that group usually will be appropriate;
- a research credit specialist is to be directly involved in the planning for a research credit study, including a determination of direct involvement by research credit specialists in delivery of the project; and
- an engagement involving the provision of a cost segregation study (or an equivalent analysis regarding the appropriate classification of assets for tax depreciation purposes) is to be performed by a member of the Cost Segregation Services practice.

42.3 Involvement of Compensation and Benefits in Golden Parachute Engagements

- 42.3.1** Designated Compensation and Benefits professionals are to be involved in and responsible for the direction of Golden Parachute services performed by KPMG for the employer. Golden Parachute services include, but are not limited to, collecting of data and documents necessary to consult on IRC Section 280G matters, calculating the impact of a change in control under IRC Section 280G, making recommendations or strategizing on IRC Section 280G matters and providing written information to individuals or companies on IRC Section 280G.
- 42.3.2** Golden Parachute services provided directly to an executive are to be directed by a Personal Financial Planning partner with the involvement of a Compensation and Benefits professional. It is essential that Personal Financial Planning and Compensation and Benefits professionals work closely on Golden Parachute engagements provided directly to executives.
- 42.3.3** Where the firm has the opportunity to provide, or to propose to provide, Golden Parachute services, firm personnel are to contact one of the designated Compensation and Benefits professionals *prior* to making a commitment to provide the services. The tax services partner, engagement services partner, or tax managing director for the employer, and/or the Personal Financial Planning partner for the executive, and the designated Compensation and Benefits professional will jointly agree on the work plan for delivery of the services. Written information and reports concerning the engagement are to be approved by a designated Compensation and Benefits professional prior to delivery to the client and only the firm approved IRC Section 280G software is to be utilized.

42.4 Involvement of Tax Controversy Services in Delivery of Federal Tax Strategies

- 42.4.1** Firm professionals involve a Tax Controversy Services (TCS) professional in the review of the appropriateness of documentation involved in the delivery of federal tax strategies where KPMG fees are expected to exceed \$250,000. A *federal tax strategy* is any strategy intended to reduce the client's U.S. federal tax, irrespective of which group delivers the strategy. Upon execution of an engagement letter, the engagement team should include a Tax Controversy Services professional who consults with the engagement partner early on in the delivery cycle of a tax strategy.
- 42.4.2** Tax Controversy Services professionals may also assist an engagement team in addressing client concerns with respect to how the current regulatory environment may impact a particular strategy. Tax Controversy Services professionals may further assist a client in establishing appropriate business purpose for proposed transactions and the relevant documentation with respect to the implementation of a tax strategy. The engagement partner for the particular engagement and the appropriate Tax Controversy Services professional should jointly determine the degree of involvement by Tax Controversy Services personnel.

May 2002

42.5 Involvement of Export Tax Management in Extraterritorial Income Exclusion Engagements

- 42.5.1** The FSC Repeal and Extraterritorial Income Exclusion (EIE) Act of 2000 (the Act), which repeals the Foreign Sales Corporation (FSC) rules and replaces them with tax rules for foreign sales, provides an opportunity to reduce the U.S. income tax due on foreign sales. The Act establishes a category of income under IRC Section 114, extraterritorial income, that is excluded from gross income to the extent it is qualifying foreign trade income. The EIE can be applied with respect to transactions occurring after September 30, 2000. Eligible taxpayers include individuals, corporations (including S corporations), partnerships and other pass-through entities.
- 42.5.2** The EIE regime contains various elections as well as complex transitional rules from the FSC regime to the EIE rules covering a significant time period (15 months or longer in certain cases) beginning on October 1, 2000. For companies without FSCs, the EIE rules are automatically applied and taxpayers must elect out of the provisions if they do not wish to apply the rules. The determination of the IRC Section 114 exclusion can range from somewhat complex to very complex. IRC Section 114, Sections 941–943 and the associated FSC regulations can be extremely complex, and the risk of inaccurate technical interpretations is substantial.
- 42.5.3** The rules raise a significant number of issues including but not limited to: (a) the need for KPMG to inform its clients of the rules and their application; (b) the possibility of underpayment (or overpayment) of tax by a client in cases where no action is taken and/or the failure to elect out of the EIE has an adverse impact on a client's foreign tax credit position; and (c) the various complex choices involving the application of both the FSC and EIE regimes during a 15-month transition period.
- 42.5.4** Although it is likely that many of the firm's larger clients (including many existing FSC users) are aware of the EIE regime, many of the firm's smaller clients, including individuals, S corporations and partnerships may not be aware of the legislation and filing requirements.
- 42.5.5** In light of the complexities associated with the EIE regime, firm personnel are required to involve a designated Export Tax Management (ETM) specialist in the preparation or review of the relevant portion of U.S. corporate, partnership and individual tax returns that include income in excess of \$2 million earned from sales leases or licenses to customers outside the U.S. for tax periods ending after September 30, 2000. The ETM specialist will review the Form 8873, the Form 1120-FSC and page 1 of the income tax return, prepared by the engagement team (or alternatively, assess whether such form should be filed). The ETM specialist will also be available to assist the engagement team in explaining the EIE rules to a client and in addressing any specific client issues.
- 42.5.6** To facilitate a timely turnaround, affected Forms 8873, Form 1120-FSC and page 1 of the income tax return, as applicable, are to be submitted for review in final or near final form with a list of open points or questions attached. All Forms 8873 and 1120-FSC are to be received by the designated ETM specialist no later than 45 calendar days in advance of the tax return filing due date. If the return cannot be delivered to the

designated ETM specialist by the due date for review, the engagement partner or manager is to make special arrangements with the designated ETM specialist.

- 42.5.7** In addition, the EIE election choices and the EIE computation should be considered when developing the budget for the tax return work. The amount of additional work required in this regard can vary widely, depending primarily on the level of qualifying foreign sales and the complexity of the issues involved. Within each tax return budget, the engagement partner or manager should allocate the appropriate number of additional hours for the engagement team's preparation of the EIE computation and for the ETM specialist's review of the returns, the EIE computation and the elections made, where applicable. It is therefore essential that the ETM specialist be involved early on in the engagement planning process to determine the estimate of the additional hours that will be needed in the tax return budget, to appropriately address the EIE issues and to plan the timing required in order to effectively address the FSC/EIE issues before the tax return filing deadline. The review time is charged to the client contract number provided by the return preparer. In cases where the time required to appropriately address the FSC/EIE issues has not been included in the tax return budget, it may be possible to bill the time separately to the client as an additional unbundled service.
- 42.5.8** The designated ETM specialist will not sign the Form 8873 (which does not require separate return preparer signature), the Form 1120-FSC nor page 1 of the income tax return. However, the ETM specialist will add his/her initial to the tax return docket in order to document that the required review has taken place. Alternatively, the engagement team may place the ETM specialist's correspondence (via e-mail or otherwise) into the tax return file as documentation for the review.
- 42.6 Involvement of Economic Downturn Consulting Services in Bankruptcy Engagements**
- 42.6.1** Prior to initiating proposal efforts for or entering into a tax engagement with a prospective or current KPMG client who is contemplating or involved in a bankruptcy proceeding or out-of-court restructuring, tax professionals are to contact one of the members of the Economic Downturn Tax Consulting Services (EDTCS) team. The EDTCS team, in turn, will work with the Department of Professional Practice—Tax and the Corporate Recovery practice relative to client and engagement acceptance, conflict of interest checks, requests for obtaining court approval for service and client service needs. A list of EDTCS professionals are on the Mergers and Acquisition homepage at <http://taxkm.us.kworld.kpmg.com/homepages/m&a/index.htm>.
- 42.6.2** Any current or prospective client in financial distress is subject to specified client and engagement acceptance procedures, scope of services and engagement letter review and approval procedures, conflicts of interest check procedures and client service considerations. Clearing potential conflicts of interest in these situations requires a detailed investigation of current firm relationships and a thorough understanding of the disinterestedness provisions of the applicable legal statutes.

May 2002

- 42.6.3 Where an existing client, not previously considered to be in financial distress, declares bankruptcy or announces an intention to declare bankruptcy, one of the members of the Corporate Recovery practice and Office of General Counsel is to be contacted relative to appropriate actions to take with respect to engagements in process.
- 42.6.4 The Federal Bankruptcy Code requires that where an advisor provides services to a party involved in a bankruptcy proceeding such advisor is a disinterested person with respect to the other parties in the bankruptcy proceeding.
- 42.6.5 Where court filings are necessary, the Office of General Counsel is contacted, and such filings are coordinated by the Office of General Counsel.
- 42.7 **Involvement of International Corporate Services Personnel in International Tax Consulting and Compliance Engagements**
- 42.7.1 In light of the issues and complexities associated with international corporate tax consulting and compliance, KPMG tax professionals should involve professionals from the International Corporate Services (ICS) practice. Form 1118, *Foreign Tax Credit-Corporations*, Form 5471, *Information Return of U.S. Persons With Respect to Certain Corporations*, Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, and other international forms and schedules should be reviewed by an ICS professional as part of the tax compliance process.
- 42.8 **Involvement of Investment Advisory Services**
- 42.8.1 Personal financial planning may include advice concerning investment matters. Most firm personnel are not investment advisors and do not render investment advice. Such investment advisory services may be offered only by personnel specifically authorized to provide these services by the investment advisory committee of KPMG Investment Advisors.
- 42.9 **Involvement of GSTT Specialist in the Review of Gift Tax, Estate Tax, and Fiduciary Income Tax Returns**
- 42.9.1 Gift tax, estate tax, and fiduciary income tax returns that KPMG prepares or reviews are reviewed by a designated GSTT specialist for generation-skipping transfers and "adequate disclosure" requirements prior to delivery to the client for filing with the Internal Revenue Service. Detailed guidance is set forth in Chapter 40 of this manual.

Chapter 43—Loaned Staff and Outsourcing Engagements

43.1	Policies
43.1.1	Loaned Staff Engagements
	The approval of the business unit professional practice partner—tax is required before a commitment is made to a client to provide loaned staff.
43.1.2	Outsourcing Engagements
	For outsourcing engagements involving audit clients, the overriding consideration is that the firm does not act or appear to act in a capacity equivalent to a member of client management or as an employee, or additionally for SEC audit clients, provide or appear to provide accounting or bookkeeping services.

Loaned Staff Engagements

43.2 General

- 43.2.1** A *loaned staff engagement* typically is one in which KPMG lends staff to a client to help the client prepare tax returns and/or assemble supporting documentation for returns. A loaned staff engagement usually takes place under the direction and supervision of the client at the client's place of business.

43.3 Loaned Staff Income Tax Compliance Engagements

- 43.3.1** We should not enter into a loaned staff engagement where KPMG personnel are treated as individuals required to sign the tax returns or claims for refund as preparers, unless we have sufficient procedures in place for the engagement team to be able to determine that positions on the returns or claims are consistent with applicable firm and professional standards. See, in general, Chapter 40 of this manual.
- 43.3.2** The approval of the business unit professional practice partner—tax is required before a commitment is made to a client to provide loaned staff. In determining whether to grant such approval, the tax professional practice partner will ascertain whether the underlying circumstances are such that a KPMG person would be required to sign a return or claim as a preparer under the applicable regulations and, if so, whether sufficient procedures will be in place in order to determine that positions taken are consistent with applicable firm and professional standards.
- 43.3.3** It is generally expected that where a loaned staff engagement is accepted, a KPMG person will sign the tax return or claim for refund. The business unit professional practice partner—tax may waive such signature requirement where it is clear, under the applicable regulations, that the involvement of our personnel is so limited as to not rise to "preparer" status (i.e., KPMG personnel will not be involved in a substantial portion of the return) or that another accounting (or law) firm will be required to sign as preparer. In all other cases, the business unit professional practice partner—tax may

May 2002

waive the signature requirement only after consultation with the partner in charge of the Department of Professional Practice—Tax.

43.4 Loaned Staff Tax Consulting Engagements

- 43.4.1** For loaned staff tax consulting engagements (i.e., engagements where KPMG tax personnel are assigned to work at a client's premises under client direction on matters other than, or in addition to, compliance) the assignment is covered by an engagement letter that provides that all advice provided by a KPMG person is to be documented and reviewed and approved by another KPMG person in the manner required by KPMG policy. Rules for documenting oral advice and for review and approval of technical correspondence and memoranda (e.g., before they are issued, technical correspondence and memoranda are reviewed by a KPMG manager or partner other than the preparer of the document and approved by a KPMG partner) are set forth in Chapter 41 of this manual. Any exception to this policy requires the express approval of the partner in charge of the Department of Professional Practice—Tax.

Tax Outsourcing Engagements

43.5 General

- 43.5.1** A *tax outsourcing engagement* is one in which we generally assume some portion of the client's function (although we do not accept management responsibilities for audit clients) and perform most of the work at the client premises.
- 43.5.2** Tax outsourcing engagement contracts are presented to a client only after the engagement and the specific terms of the contract have been approved by the Department of Professional Practice—Tax and, in the case of an outsourcing engagement involving an audit client, by the Independence Group in the Department of Professional Practice—Assurance. A model tax outsourcing engagement agreement is recommended for tax outsourcing engagements and is posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 43.5.3** The client must designate a managerial level individual or individuals (*client relationship manager*) who will be responsible for: overseeing the services provided under the tax outsourcing engagement; evaluating the adequacy of the services performed and any findings that result; making all management decisions, including accepting responsibility for the results of the services; and establishing and maintaining internal controls, including monitoring ongoing activities. KPMG designates a member of the tax outsourcing engagement team to act as *KPMG relationship manager*. This individual has overall managerial responsibility for KPMG's provision of tax outsourcing services under the engagement. The KPMG relationship manager is the primary contact for the client relationship manager.
- 43.5.4** When performing services under a tax outsourcing engagement, KPMG personnel are not to act or appear to act in a capacity equivalent to a member of client management or as an employee, or for audit clients, provide or appear to provide accounting or bookkeeping services.

- 43.5.5** KPMG tax personnel are not to provide accounting advice to clients during the course of a tax outsourcing engagement. If the outsourcing client is a KPMG audit client, questions on accounting issues are to be coordinated with the audit engagement team. Additional guidance regarding the coordination between the audit and tax engagement teams on financial statement tax provision matters is set forth in Chapter 44 of this manual. If the outsourcing client is not a KPMG audit client, KPMG tax personnel are to inform the client that issues and questions concerning accounting matters must be addressed by the client directly to its own auditing firm.
- 43.5.6** Tax compliance and consulting services performed under an outsourcing engagement are performed in accordance with firm procedures. See, in general, Chapter 40 of this manual. The appropriate KPMG person signs any tax return prepared under the engagement as preparer. All advice provided by a KPMG person under an engagement to provide outsourcing services is documented, reviewed and approved by another KPMG person in the manner required by KPMG policy as set forth in Chapter 41 of this manual. Other firm procedures described in this manual pertinent to the performance of tax outsourcing engagements should also be followed.
- 43.6 Outsourcing Engagements With Audit Clients**
- 43.6.1** To the extent that KPMG's relationship with the client requires auditor independence, KPMG and its personnel are not to undertake any task or function which KPMG determines would impair its independence under the applicable auditor independence rules, as promulgated by the AICPA, SEC, state boards of accountancy and any other regulatory authority exercising competent jurisdiction over KPMG and KPMG's professional practice policies.
- 43.6.2** For audit clients, the overriding consideration in an outsourcing engagement is that the firm does not act or appear to act in a capacity equivalent to a member of client management or as an employee. Additional guidance is set forth in Chapter 12 of the *RMM—U.S.* Firm personnel are to remain cognizant of the following with respect to tax outsourcing engagements with audit clients:
- KPMG personnel are not to perform any bookkeeping functions or act in the role of management or as an employee of the client. Examples of bookkeeping functions include preparing client journal entries, authorizing or approving client transactions, preparing client source documents or original data and making changes to client source documents;
 - KPMG personnel are not to have custody of client assets (including cash), are not to have control over the remittance of tax payments or the receipt of tax refunds, and are not to prepare or sign checks on behalf of clients. KPMG personnel should not accept responsibility to sign or co-sign client checks, maintain a client's bank account or otherwise have custody of a client's funds for purposes of making payroll or other disbursements. KPMG should also not make disbursements from its own account for these purposes on behalf of an audit client, nor should it receive tax refunds or other payments on behalf of an audit client. See also Chapter 40 of this manual related to check signing engagements and other occasional disbursements for non-audit clients;

May 2002

- KPMG personnel are not to be identified as client employees in client directories or other publications. However, [KPMG employee's name], followed by "KPMG Tax Consultant" or similar title identifying the KPMG professional as an employee of KPMG in client directories or other publications, would be acceptable;
- KPMG personnel should not be referred to as client "manager" or "director" or similar management title. However "KPMG tax manager" or "KPMG tax director" or similar title identifying the KPMG professional as an employee of KPMG would be acceptable; and
- KPMG personnel are not to use client's letterhead or internal correspondence forms in communications. KPMG personnel with an address on the client's e-mail system should include a KPMG identifier in their e-mail address. For example, "[KPMG employee name]-kpmg@client.com" would be acceptable.

Chapter 44—Tax Personnel Involvement in Accounting Matters

44.1 Policies

44.1.1 General

A tax review by a tax management group member is required in all audits of financial statements, including audits of financial statements of "nontaxable entities," such as partnerships, S corporations, employee benefit plans and tax-exempt entities.

The assurance engagement partner has overall responsibility for the audit work performed on the tax provision and determining that the engagement team includes tax personnel with appropriate industry knowledge and technical expertise.

Except as described in section 44.4 of this chapter (concerning employee benefit plans), a tax partner or a designated tax managing director is responsible for leading the review of the tax provision performed by tax personnel.

44.1.2 Filings by Non-U.S. Companies

In filings by non-U.S. companies involving U.S. GAAP financial statements or a reconciliation to U.S. GAAP, the member firm engagement team should include personnel with appropriate knowledge and experience in local tax laws and regulations and with U.S. GAAP on accounting for income taxes.

44.1.3 Employee Benefit Plans

Required tax reviews in audits of financial statements of employee benefit plans are to be performed by a partner, tax managing director, senior manager or manager in the Compensation and Benefits tax practice.

44.1.4 Accounting Advice

KPMG tax professionals remain cognizant of restrictions on the provision of accounting advice by tax personnel.

44.1.5 Financial Information Included in Personal Financial Plans

When we submit a written personal financial plan containing unaudited personal financial statements to a client, a suitable report accompanies the financial statements.

44.2 General

44.2.1

A tax review by a tax management group member is required in *all* audits of financial statements, including audits of financial statements of "nontaxable entities," such as partnerships, S corporations and "tax-exempt entities," such as not-for-profit and

May 2002

governmental entities, except as described in section 44.4 of this chapter, regarding certain audits of financial statements of certain employee benefit plans. The “tax review” includes: (a) a review of the client’s tax status; (b) a review of tax calculations, related income statement and balance sheet accounts and other information; (c) a review of financial statement presentation and disclosure; and (d) consideration of whether such tax calculations and related conclusions appear appropriate based on tax laws and regulations and applicable accounting literature.

- 44.2.2** Consistent with our approach in other areas of the audit, the assurance engagement partner has overall responsibility for the audit work performed on the tax provision and determining that the engagement team includes tax personnel with appropriate industry knowledge and technical expertise.
- 44.2.3** Except as described in paragraph 44.2.6 of this chapter, a tax partner or a *designated* tax managing director is responsible for leading the review of the tax provision performed by tax personnel. Tax managing directors may be designated to lead tax reviews by the Engagement Services Tax Practice after attending specified training programs and obtaining the approvals of business unit professional practice partners and the Department of Professional Practice—Tax. Tax senior managers, managers and other tax personnel may assist the tax partner or designated tax managing director in performing the tax review, however, the tax partner or designated tax managing director retains responsibility for the tax review.
- 44.2.4** For audits of financial statements of non-SEC clients (SEC clients are defined in the *SEC Manual* section 1.2) that are not considered to be high-risk engagements (engagements may be identified as high-risk by the assurance engagement partner, business unit professional practice partner—assurance, Area Risk Management Partner or the Department of Professional Practice—Assurance), the tax partner or designated tax managing director, with the agreement of the assurance engagement partner, may assign the review of the tax provision and related work papers to a tax senior manager or manager. When the tax review has been assigned to a tax senior manager or manager, the tax partner or designated tax managing director is required to review the Tax Review Memorandum and sign the memorandum to document the tax partner’s or designated tax managing director’s review of the memorandum and agreement with the conclusions discussed in the memorandum.
- 44.2.5** The audit work papers related to the tax provision document our audit procedures and conclusions with respect to the client’s tax provision. The audit work papers are to include: (a) documentation of the client’s tax calculations with appropriate evidence of our audit work and conclusions; and (b) a Tax Review Memorandum that addresses significant matters related to the client’s tax calculations, prepared and signed by appropriate tax personnel on the engagement and approved by the assurance engagement partner and manager. Tax provision work papers should be retained and filed as part of the *audit* work papers for the engagement. Accordingly, those work papers are subject to the retention policies for audit work papers as discussed in Chapter 24 of the *RMM—U.S.*
- 44.2.6** A tax partner or a designated tax managing director is required to be involved in timely quarterly reviews of interim financial information of SEC clients. The extent of that

involvement should be determined by the assurance engagement partner and tax partner or designated tax managing director based on the specific circumstances. That involvement should be documented in the timely quarterly review work papers.

- 44.2.7** For additional guidance, see PPL 01-122, which can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

44.3 Filings by Non-U.S. Companies

- 44.3.1** In filings by non-U.S. companies involving U.S. GAAP financial statements or a reconciliation to U.S. GAAP, the member firm engagement team should include personnel with appropriate knowledge and experience in local tax laws and regulations and with U.S. GAAP on accounting for income taxes. Local tax professionals in the foreign country should participate in the engagement and document their participation with an appropriate tax review memorandum that addresses the U.S. GAAP provision for income taxes. In addition, a U.S. tax partner or designated tax managing director should assist the filing reviewer in the performance of procedures relating to the filing, as specified in Section 61 of the *SEC Manual*, unless it is determined that the involvement of a U.S. tax partner or designated tax managing director is not necessary based on the member firm engagement team's level of knowledge and experience in U.S. GAAP on accounting for income taxes.

44.4 Employee Benefit Plans

- 44.4.1** Required tax reviews in audits of financial statements of employee benefit plans are to be performed by a partner, tax managing director, senior manager or manager in the Compensation and Benefits tax practice. A tax review is required for all audits of financial statements of health and welfare benefit plans. For audits of financial statements of all other employee benefit plans, a tax review is required: (a) when a tax review has not been completed by the Compensation and Benefits tax practice in the past two years; and (b) in other circumstances, such as those indicated in WP-425, *Employee Benefit Plan Tax Review Checklist*. Completion of WP-425 is required in all instances when the engagement team concludes that a tax review in connection with audits of financial statements of employee benefit plans, other than health and welfare benefit plans, is *not* necessary.

44.5 Time Charges

- 44.5.1** Time incurred by tax personnel in preparing detailed work papers for the tax provision and reviewing the tax provision work papers is charged to the audit contract. Additional time incurred by tax personnel during the audit process that relates only to the preparation of the tax return or other tax projects is charged to tax contracts. The assurance engagement partner and tax partner or designated tax managing director should agree on the specific arrangements related to time charges and fees during the audit planning process.

May 2002

Accounting Advice**44.6 General**

- 44.6.1** KPMG tax professionals remain cognizant of restrictions on the provision of accounting advice by tax personnel.

44.7 Audit Clients

- 44.7.1** For audit clients, any accounting advice is to be provided by the Business Management Process (BMP) partner or manager responsible for the account.

44.8 Non-audit Clients

- 44.8.1** For non-audit clients, firm personnel are to remain cognizant of Statement on Auditing Standards No. 50, *Reports on the Application of Accounting Principles* (SAS 50), when providing tax advice that may have an effect on the client's financial statements. SAS 50 applies to written accounting advice as well as to oral accounting advice when we believe such oral advice will be used by the client as an important factor considered in reaching a decision. Among other things, SAS 50 requires us to consult with the entity's continuing auditor to ascertain all the available facts relevant to forming a professional conclusion on accounting matters. In most circumstances, tax personnel should inform a non-audit client considering our tax advice that we are unable to provide any accounting advice relative thereto, and that the client must seek such accounting advice from its own audit firm. If the client nevertheless insists on accounting advice from KPMG, a BMP partner must become involved so that the provisions of SAS 50 may be properly applied.

- 44.8.2** SAS 50 also applies to oral or written advice to intermediaries on the application of accounting principles to a specific transaction, or when we believe the advice is intended to be used by a principal to the transaction as an important factor considered in reaching a decision.

- 44.8.3** The firm's policies with respect to SAS 50 engagements are set forth in Chapter 63 of the *Reports Manual*.

44.9 Financial Information Included in Personal Financial Plans

- 44.9.1** When we submit a written personal financial plan containing unaudited personal financial statements to a client, a suitable report accompanies the financial statements. That report states that the unaudited financial statements:
- are designed solely to help develop the financial plan;
 - may be incomplete or may contain other departures from generally accepted accounting principles and should not be used to obtain credit or for any purposes other than developing the personal financial plan; and
 - have not been audited, reviewed or compiled.

- 44.9.2** Following is an illustration of an appropriate report when all of the conditions stated in paragraph 44.9.3 are met.

The accompanying Statement of Financial Condition of [Client name], as of December 31, 20XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or may contain other departures from generally accepted accounting principles and should not be used to obtain credit or for any purposes other than developing your financial plan. We have not audited, reviewed or compiled the statement.

Each of the personal financial statements includes a reference to the accountant's report.

- 44.9.3** The preceding report is appropriate only when all of the following conditions exist:
- we have an understanding with the client, stated in the engagement letter, that the financial statements:
 - will be used solely to assist the client and the client's advisors in developing the client's personal financial goals and objectives,
 - will not be used to obtain credit or for any purposes other than developing these goals and objectives; and
 - nothing comes to our attention during the engagement that would cause us to believe that the financial statements will be used to obtain credit or for any purposes other than developing the client's financial goals and objectives.
- 44.9.4** The *Reports Manual* presents guidance for our reports accompanying financial statements for all other situations.

Chapter 45—Independence Considerations Associated With Tax Services

45.1 Policies

In developing a particular tax solution or delivering other tax consulting services, firm professionals consider potential independence issues that may arise where the solution or service is offered to audit clients, particularly audit clients subject to the rules and regulations of the U.S. Securities and Exchange Commission (SEC). Additional guidance regarding non-audit services that may impair independence is set forth in Chapter 12 of the *RMM—U.S.*

45.2 General

45.2.1 In delivering a particular tax solution or other tax consulting services to an audit client, firm professionals consider potential independence issues.

45.2.2 Examples of limitations in our work for audit clients are:

- we cannot exercise managerial control over any aspect of their business or otherwise act as an employee;
- we cannot supervise client employees in the performance of their normal recurring activities;
- we cannot have custody of their assets at any time; and
- we cannot process or produce lists or reports that will become part of the “basic accounting records” on which, at least in part, the firm would base its audit opinion, and we cannot otherwise assume responsibility for the accounting records or financial statements of the audit client. Examples include preparing source documents, in electronic or other form, such as purchase orders, payroll time records and journal entries.

45.2.3 Independence considerations related to other specific tax services are discussed in their respective chapters throughout this manual.

45.3 Specific Services That May Impair Independence

45.3.1 The following restrictions apply primarily to SEC audit clients of the firm. For purposes of these rules, *SEC audit client* generally includes affiliates of the audit client. These restrictions are largely based on the principal limitations described in paragraph 45.2.2 of this chapter.

45.3.2 This discussion is general in nature and is not intended to be all-inclusive. Additional guidance regarding *non-audit* services that may impair independence is set forth in Chapter 12 of the *RMM—U.S.*

May 2002

- 45.3.3** Firm professionals are to consult with the Department of Professional Practice—Tax to address potential independence issues that may be associated with delivery of tax solutions or other tax consulting services to audit clients. The Department of Professional Practice—Tax will in turn consult with the Independence Group in the Department of Professional Practice—Assurance, as appropriate. Tax professionals should discuss the specific services contemplated to be provided to an audit client with the assurance partner for the audit client prior to agreeing to provide such services.

45.4 Bookkeeping Services

- 45.4.1** Bookkeeping services may generally not be performed for an SEC audit client. Bookkeeping services include preparation of source documents underlying the financial statements. Thus, KPMG personnel should not prepare journal entries (including journal entries evidencing tax transactions) for SEC audit clients. KPMG personnel may, however, provide suggested journal entries with respect to an SEC audit client's income tax accrual subject to its further review and approval. In limited circumstances, bookkeeping services may be performed for foreign locations of an SEC audit client.

45.5 Payroll Services

- 45.5.1** Payroll services may generally not be provided to SEC audit clients. In certain circumstances, solely performing payroll related tax calculations for an SEC audit client in a *foreign* location with respect to its expatriate employees may be permitted provided we are not otherwise involved in processing the payroll or handling tax remittances, and further provided such calculations are subject to review and approval by the client.

45.6 Custody of Assets

- 45.6.1** KPMG personnel should not accept responsibility to sign or co-sign client checks, maintain a client's bank account or otherwise have custody of a client's funds for purposes of making payroll or other disbursements. KPMG should also not make disbursements from its own account for these purposes on behalf of a client and should not receive tax refunds or other payments on behalf of a client. Additional guidance related to check signing engagements and other occasional disbursements for non-audit clients is set forth in Chapter 40 of this manual.

45.7 Management Functions

- 45.7.1** KPMG personnel may not act as directors, officers or employees of an SEC audit client and may not perform any decision making, supervising or other ongoing monitoring function for such a client. It is important that all communications with an SEC audit client make clear that client personnel are responsible for making management decisions. KPMG personnel should also not perform monitoring activities on behalf of an SEC audit client, such as tracking the status of receivables from expatriate employees. KPMG personnel, however, may assist audit clients with respect to negotiations with third parties in certain circumstances, such as in the negotiation of an incentives package with state and/or local government officials, but cannot assume the lead role in the negotiations. Questions regarding the permissibility of these services

should be referred to the Department of Professional Practice—Tax, who will consult with the Independence Group in the Department of Professional Practice—Assurance, as appropriate.

45.8 Appraisal or Valuation Services

- 45.8.1** Appraisal or valuation services may not be provided to an SEC audit client where the results of the services can be expected to be material to the financial statements or when the results of the services will be audited by the firm during an audit of the client's financial statements. Appraisal or valuation services, however, generally are permissible where performed *solely* for tax planning or tax compliance purposes. For example, a valuation service for an SEC audit client to support the pricing of an *intercompany transaction* in order to comply with tax laws or regulations is generally permissible, but a valuation service to support the sale price of assets sold to an *unrelated party* is not permissible.

45.9 Market Research Studies

- 45.9.1** Where material, market research studies may not be provided to an SEC audit client. However, the firm's independence would not be impaired if market research services are limited to gathering or analyzing market data, provided the firm's work does not result in specific recommendations or conclusions. For example, firm professionals may assist audit clients in analyzing potential sites for new locations. Our analysis, however, must be based on client-supplied criteria and the location decision must be made by the client.

45.10 Economic Impact Analysis

- 45.10.1** KPMG cannot perform economic impact studies for SEC audit clients. SEC audit clients must contract with a non-KPMG firm for the performance of economic impact studies.

45.11 Tax-related Projections

- 45.11.1** Firm professionals should not prepare projections of future tax liabilities/savings for other than internal purposes. Projections may be used internally by the client to help the client decide whether to proceed with a particular tax solution or service.
- 45.11.2** For example, KPMG prepared projections should not be used in making presentations to a government authority to help the government authority decide whether to grant tax or business incentives because the projections could be interpreted as a surrogate for an economic impact analysis (see paragraph 45.10.1 of this chapter). Implicit in such projections are assumptions about future growth of the client that could be considered to impair KPMG's independence. This restriction applies even if the underlying assumptions are provided by the audit client.
- 45.11.3** It is permissible for KPMG to advise the client of relevant matters to consider in developing tax projections to provide to governmental authorities, provided the client

May 2002

gathers the underlying information, inputs all data into the model and prepares the projections itself (and does not use KPMG software in preparing the projections).

45.12 Web-hosting Services

45.12.1 Providing Web-hosting services to an SEC audit client will generally impair independence, as it could be expected that the hosted software would interact with the client's general ledger system, and information provided by the hosted software may become part of the financial statements.

45.12.2 However, the SEC has recognized that CPA firms historically have provided tax services to audit clients and that the provision of tax services should not be considered to impair independence. Accordingly, if the primary purpose of a particular Web-hosting or application service provider activity is to provide a tax service (e.g., compilation of sales and use tax returns), such a service may be provided to an SEC audit client without impairing independence. Certain services provided by the firm, although peripherally related to tax services, are not themselves tax services (e.g., investment consulting, international human resource consulting, expatriate assignment management services). Provision of Web-hosting, or serving as an application service provider, for such a peripheral service for an SEC audit client would impair independence. An exception might be where the Web-hosting services that do not interact with the client's general ledger system, such as conducting an employee satisfaction survey.

45.13 IES Tax Services

45.13.1 A matrix of tax services that are permitted and are not permitted to be provided by the International Executive Services (IES) practice to expatriate employees of SEC audit clients is on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>. It is the responsibility of the IES management group to ensure that only permitted IES services (i.e., services provided with respect to an audit client's expatriate employees) are provided to an audit client.

Part V—Dealings With Third Parties

In this Part This part contains five chapters:

Chapter	Title
50	Client and Third-party Access to Tax-related Materials
51	The Practice of Law and Other Legal Matters
52	Tax Services Alliances
53	Use of Subcontractors
54	Relationship With KPMG Consulting, Inc.

Chapter 50—Client and Third-party Access to Tax-related Materials

50.1	Policies
50.1.1	Disclosure of Tax Return Information
	Firm personnel promptly consult with the business unit professional practice partner—tax when the firm receives a request or demand (other than a summons, subpoena or a request by an attorney) to disclose any information obtained in connection with the provision of tax advice or the preparation of a client's tax returns.
50.1.2	Consultation With Office of General Counsel
	Firm personnel promptly consult with the firm's Office of General Counsel:
	<ul style="list-style-type: none"> ▪ prior to undertaking an engagement to assist an attorney in connection with the defense of potential or existing fraud cases (<i>and with the Department of Professional Practice—Tax</i>); ▪ as soon as the firm or firm personnel receive a summons, a subpoena or a request by an attorney for tax return information; or ▪ prior to granting a client's request for original tax work papers.
50.1.3	Access to Work Papers by Client or by Successor or Due Diligence Tax Advisor
	Prior to providing access to work papers to a successor or due diligence tax advisor, we obtain the client's written permission and the other tax advisor's agreement and acceptance of a letter stating the purpose and limitations of the other tax advisor's review and that the other tax advisor will not provide expert testimony or provide litigation support services concerning the quality of our tax work. Firm personnel consult with the Office of General Counsel to resolve questions regarding access to tax work papers by other tax advisors.

50.2 Disclosure of Tax Return Information

- 50.2.1** Section 7216(a) of the Code makes it a criminal offense for a person who is engaged in the business of preparing or providing services in connection with the preparation of income tax returns to disclose any information furnished to him or her in connection with the preparation of such tax returns. This prohibition against disclosure of income tax return information, however, does not apply to disclosures made pursuant to: (a) the taxpayer's written consent; (b) an IRS summons or subpoena; (c) a court order; (d) a subpoena issued by a grand jury; or (e) other administrative orders, demands or subpoenas issued by any federal or state agency, body or commission charged with the regulation of tax return preparers.

May 2002

- 50.2.2** Firm personnel promptly consult with the business unit professional practice partner—tax when the firm receives a request or demand (other than a summons, subpoena or a request by an attorney) to disclose any information in connection with the provision of tax advice or the preparation of a client's tax returns. As stated in paragraphs 50.6.2, 50.7.1 and 50.9.2 of this chapter, the firm's Office of General Counsel is promptly contacted upon receipt of a summons, subpoena or a request by an attorney for tax return information.

IRS Access to Independent Accountants' Work Papers

50.3 IRS Audits and Examination

- 50.3.1** In representing taxpayers that are under examination by the Internal Revenue Service, the firm is often faced with requests from the IRS for access to our work papers through informal processes such as information data requests and more formal processes such as summonses. We can only provide such access with consent of the client.

50.4 Definitions of Accountants' Work Papers

- 50.4.1** The *Internal Revenue Manual (IRM)* distinguishes among tax reconciliation work papers, audit work papers and tax accrual work papers as follows:
- tax reconciliation work papers are work papers used in assembling and compiling data to be placed on a tax return. This includes final trial balances, schedules of consolidating and adjusting entries, and information used to trace financial information to the tax return;
 - audit work papers are work papers retained by the independent accountant as to the procedures followed, the tests performed, the information obtained and the conclusions reached pertinent to the examination. This includes work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents, and schedules or commentaries prepared or obtained by the auditor;
 - tax accrual work papers are work papers that reflect the estimate of a company's tax contingency liability. The *IRM* states, "These work papers are generally prepared and maintained by the taxpayer but, in some cases, all or portions of them may be maintained by the independent accountant." This includes summaries of the transactions recorded in the general ledger with respect to income tax accounts, computations of the tax provision for the current year and memoranda discussing items that are reflected in the financial statements as income or expense if the ultimate tax treatment is unclear.

50.5 IRS Positions Regarding Access to Work Papers

50.5.1 The *IRM* specifies the following IRS positions regarding work papers:

- tax reconciliation work papers should be requested by the agent at the beginning of a tax examination;
- audit and tax accrual work papers will not be sought as a matter of standard examining procedure. Examiners are cautioned to request only those work papers believed to be materially relevant to the investigation. In addition, examiners are cautioned that the primary source of information is the taxpayer's records, and audit work papers should be used only as a collateral source of information; and
- records may not be summoned unless the action is first approved by the agent's Team Manager.

50.5.2 On occasion, agents ask firm personnel to produce copies of confidential auditor disclosures and correspondence related to the AICPA's Statements on Auditing Standards Nos. 54, 60, 61 and 82, *Illegal Acts by Clients*, *Communication of Internal Control Related Matters Noted in an Audit*, *Communication With Audit Committees*, and *Consideration of Fraud in a Financial Statement Audit*, respectively. This information is confidential and is not to be disclosed except in response to a summons or subpoena, or if the formal consent of the taxpayer is obtained in accordance with Regulation Section 301.7216-3.

50.5.3 The requirements that IRS agents face, together with the necessary reviews by other IRS personnel, make it exceptional for agents to seek audit or tax accrual work papers from the independent accountants. Personnel promptly inform the Office of General Counsel if any such request is made and *before* any information is released.

IRS Summonses, Subpoenas and Other Legal Demands**50.6 IRS Summonses**

50.6.1 Section 7602 of the Code authorizes the IRS "to examine any books, papers, records, or other data which may be relevant or material" for the purpose of "ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability." Under this Section of the Code, the IRS has broad powers to issue summonses for records and testimony in determining whether taxpayers are complying with the tax laws.

50.6.2 If the IRS serves a summons upon the firm or firm personnel for the production of records or for testimony, firm personnel contact the Office of General Counsel immediately in accordance with firm procedures for subpoenas before taking further action. Additional guidance is set forth in Chapter 31 of the *RM—U.S.* Firm personnel make no statement or agreement with the IRS agent and refer any inquiries concerning the summons to the Office of General Counsel.

May 2002

50.6.3 Once the IRS issues a summons, the rights and defenses of the various parties tend to become frozen, although they may become the subject of extended litigation. At this point, the firm is not allowed to transfer, return to the client or otherwise dispose of any records pertaining to the investigation.

50.6.4 Unless the client secures a court order setting aside the summons, in most circumstances we have a legal obligation to comply regardless of whether the client consents.

50.7 Subpoenas and Other Legal Demands

50.7.1 When a subpoena, civil investigative demand or other legal demand (including a request by an attorney for tax return information of the attorney's client) is received, personnel contact the Office of General Counsel immediately in accordance with firm procedures for subpoenas before taking further action. Additional guidance is set forth in Chapter 31 of the *RMM—U.S.*

50.8 Responding to IRS Summons, Subpoenas and Other Legal Demands

50.8.1 After initial consultation with the Office of General Counsel regarding an IRS summons, subpoena and other legal demand, firm personnel work closely with the Office of General Counsel in responding to requests for documents and other information and any related issues that may arise.

50.8.2 Firm personnel promptly inform the firm's Office of General Counsel and the Department of Professional Practice—Tax of any problems that arise in this area with either the IRS or clients.

50.9 Access to Tax Work Papers by Client or by Successor or Due Diligence Tax Advisor

50.9.1 We usually accommodate a client's or former client's written request for copies of the tax work papers. Prior to complying with such a request, however, we reach an understanding with the client or former client about the payment of any reproduction expenses. An exception to the general rule of complying with the request for work papers exists if we anticipate that the client or former client might be contemplating some legal action or claim against us. In this event, we consult the firm's Office of General Counsel and the Department of Professional Practice—Tax, as we may refuse or limit access to our work papers or require assurances from the party seeking the information.

50.9.2 Prior to granting a request for *original* tax work papers, firm personnel contact the firm's Office of General Counsel and obtain a written request from the client or former client. We may comply with a client's or former client's request for data that *they* supplied, whether in the form of notes, memoranda or original records, provided we retain copies or make notes in our work papers indicating the source of the data.

50.10 Review of Tax Work Papers by Successor or Due Diligence Tax Advisor

- 50.10.1** If the firm, in its capacity as a client's tax advisor, is replaced by another tax advisor, or if our client is the target of a proposed acquisition, our successor or the tax advisor to the acquirer may request permission to review our tax work papers. We explain to the other tax advisor that the tax work papers are the property of the firm. We consider these requests and may grant access in accordance with the guidelines in the following paragraphs, provided the client gives us written permission to do so.
- 50.10.2** We obtain the written permission of the client and the other tax advisor's agreement and written acceptance of a letter that states the purpose and limitations of the other tax advisor's review and provides that the other tax advisor will not provide expert testimony or provide litigation support services concerning the quality of our work. Usually, the letter also addresses the other tax advisor's obligations regarding copies or information otherwise derived from our work papers. A copy of this letter is provided to the former client. A standard letter is located on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.
- 50.10.3** We resolve problems with a former client, such as unpaid fees, before giving the other tax advisor access to our work papers. There may be other valid reasons for denying other tax advisors access to our work papers, such as pending or threatened litigation against KPMG.
- 50.10.4** If the tax services engagement partner or tax managing director approves the other tax advisor's request and the above requirements are met, a representative of the firm supervises the inspection by the other tax advisor. Access need not include proprietary KPMG information, methodology and tools and usually does not include information related to engagement administration, such as administrative materials, time summaries, interoffice arrangements and billing information. Firm personnel consult with the Office of General Counsel to resolve questions regarding access to tax work papers by other tax advisors.

Chapter 51—The Practice of Law and Other Legal Matters

51.1	Policies
51.1.1	Unauthorized Practice of Law
	Firm professionals do not engage in the unauthorized practice of law.
51.1.2	Involvement of Legal Counsel
	In cases involving issues that ultimately may proceed to litigation, firm personnel exercise judgment in deciding whether and when to recommend to a client that legal counsel also be retained.
51.1.3	Legal Services Provided by a KPMG International Member Firm
	Engagement letters issued by KPMG LLP do not provide for the provision of otherwise allowable legal services by KPMG International member firms.
51.1.4	Interaction with Outside Counsel
	Where KPMG is working in conjunction with a law firm in delivering services or tax solutions to a tax client, we make it clear to clients that they are responsible for separately engaging legal counsel.
51.1.5	Providing Legal Documents to Clients
	Whether provided directly to a client's legal counsel, or to the client with instructions to give to legal counsel, all sample documents provided by KPMG personnel contain a legend that the sample documents are intended for the sole purpose of suggesting appropriate language for consideration by the client's legal counsel with respect to legal documents that legal counsel is responsible for drafting.
51.1.6	Client Contracts
	Contracts with clients and third parties related to tax services are reviewed and approved by the Office of General Counsel prior to execution.

51.2 Unauthorized Practice of Law

- 51.2.1** Firm professionals do not engage in the unauthorized practice of law.
- 51.2.2** Refer to Chapter 21 of this manual for a discussion regarding holding out as an attorney.

May 2002

51.3 Involvement of Legal Counsel

- 51.3.1** In cases involving issues that ultimately may proceed to litigation, firm personnel exercise judgment in deciding whether and when to recommend to a client that legal counsel also be retained.
- 51.3.2** If we anticipate litigation with respect to our services in a matter, clients are advised that they may be required to separately engage and pay for legal counsel.
- 51.3.3** See Chapter 61 of this manual for a discussion of the attorney-client privilege and Chapters 60, 63 and 64 for a discussion of other matters involving legal counsel, such as the preparation of a tax protest that may lead to litigation, practice before the U.S. Tax Court and tax-related litigation services.

51.4 Legal Services Provided by a KPMG International Member Firm

- 51.4.1** A discussion of legal services provided by KPMG International member firms and the applicable standards associated with such services is set forth in Chapter 37 of this manual. Engagement letters issued by the U.S. firm do not provide for the provision of otherwise allowable legal services by KPMG International member firms. Care should be exercised such that multi-firm engagement letters issued by the U.S. firm advise clients that they are to separately engage legal counsel.

51.5 Interaction With Outside Counsel

- 51.5.1** Firm professionals should exercise caution in their provision of tax services to clients, as certain instances may arise wherein the services we provide may be construed as the unauthorized practice of law. Where KPMG is working in conjunction with a law firm in delivering services or tax solutions to a client, we make it clear to the client that it is responsible for separately engaging and paying legal counsel and the client alone is responsible for the selection of specific legal counsel to use.

51.6 Subcontracting With or Referring Clients to a Law Firm

- 51.6.1** In connection with our provision of tax services and solutions to clients, instances may arise where a client is required to engage legal counsel in order to implement a service or solution. In such instances, it is often beneficial to the client to engage legal counsel familiar with the service or solution offering. Firm professionals may be asked to refer legal counsel to a client or may seek to subcontract with legal counsel to provide our tax services to clients. Such engagements implicate two important areas:
- **Alliance** — When KPMG and a law firm jointly provide services to a client with respect to a tax service or solution, clients must separately engage KPMG and the law firm. In addition, a discussion of alliances and the underlying approval process is set forth in Chapter 52 of this manual.
 - **Subcontracts** — KPMG does not subcontract with a law firm. KPMG subcontracting of legal counsel in implementing a tax service or solution may give rise to a claim that the firm is engaged in the unauthorized practice of law or is

engaged in an unallowable fee sharing arrangement with a law firm. While legal counsel can advise KPMG on various tax services or solutions, to the extent that legal counsel is involved in providing services directly to clients, clients should separately engage and pay counsel.

51.7 Providing Legal Documents to Clients

- 51.7.1** Many tax consulting and tax solution engagements offered by the tax practice require that legal documents be prepared by the client's counsel as part of implementation of the offering. As a means of leveraging the firm's collective experience, firm personnel may seek to provide sample legal documents to clients for their consideration. This practice may be viewed by clients as a means of speeding up and reducing costs associated with the implementation process. To this end, clients may be inclined to simply retype and adapt these documents for their own use without consulting legal counsel.
- 51.7.2** In accordance with existing professional standards, the firm, its partners and its employees do not practice law or render legal services to clients. Where firm personnel provide sample documents to clients, it is possible that these documents will be adapted and used without proper consultation with legal counsel. Consequently, it is possible that by providing sample legal documents to clients, the firm could be viewed as engaged in the unauthorized practice of law.
- 51.7.3** It is recognized, however, that the provision of sample documents for consideration by legal counsel in drafting the actual documents may facilitate implementation of tax consulting or tax solutions engagements. In those circumstances, it is preferable that such documents be provided directly to a client's legal counsel. The term "legal counsel" refers to the client's outside legal counsel. The term also refers to the client's internal legal counsel in those cases where the client relies on internal legal counsel for substantive legal advice in connection with the type of transaction or strategy that is the subject of our tax consulting service. In those situations where it is impracticable to provide sample documents directly to the client's legal counsel, such documents may be provided to the client provided the client is explicitly instructed to give the documents to legal counsel for consideration in drafting the required documents.
- 51.7.4** Whether provided directly to a client's legal counsel, or to the client with instructions to give to legal counsel, all sample documents provided by KPMG personnel contain the following legend:

This document is intended for the sole purpose of suggesting appropriate language for consideration by the client's legal counsel with respect to legal documents that legal counsel is responsible for drafting.

The above legend is also included on all sample legal documents included in internal toolkits.

May 2002

51.7.5 Sample documents so provided are to be accompanied with a transmittal letter that makes clear their intended use. Standard transmittal letters are available for reference on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

51.7.6 Firm policy relative to drafting of employee plan documents is set forth in Chapter 31 of the *RMM—U.S.*

51.8 Client Contracts

51.8.1 Contracts with clients and third parties related to tax services are reviewed and approved by the Office of General Counsel prior to execution. (This requirement does not apply to most engagement letters.) The partner in charge of the Department of Professional Practice—Tax is copied on requests to the Office of General Counsel to draft or review such contracts.

Chapter 52—Tax Services Alliances

52.1 Policies

52.1.1 General

An *alliance* is a business relationship between KPMG and an outside firm in which the parties intend to work together for more than a single transaction.

Only a partner may initiate discussions with another firm for consideration of an alliance.

52.1.2 Level 1 versus Level 2 Alliances

Level 2 alliances generally involve exclusive arrangements with a third party whereby KPMG is precluded from marketing or delivering similar services with anyone else, public marketing, or a financial commitment by KPMG.

Level 1 alliances are generally all other alliances not considered Level 2 alliances.

52.1.3 Independence Considerations

Due to independence considerations, the firm does not enter into alliances with SEC audit clients, but may enter into alliances with non-SEC audit clients if not material to either the firm or the non-SEC audit client.

52.1.4 Alliance Approval Process

The sponsoring partner involves a partner or senior manager in the Strategic Alliances & New Ventures practice (SANV) to determine whether the proposed alliance may be appropriate for the firm from a business perspective, and the proposed alliance is approved by the applicable national practice leader (e.g., compensation and benefits, state and local tax services). If so, SANV and the sponsoring partner work together to further develop the business case and structure the appropriate relationship with the proposed alliance partner for further approval by the partner in charge of SANV. A Prospective Alliance Form (PAF) and related materials are developed and submitted to the partner in charge of the Department of Professional Practice—Tax for approval. Upon the Department of Professional Practice—Tax's approval, the documents are forwarded to the vice chairman—tax services for final approval.

The approval requirements for Level 2 alliances are the same as for Level 1 alliances, except that the Management Committee also must approve the alliance.

May 2002

52.1.5 Customer-directed Tax Services

Customer-directed tax services are broadly defined as services provided by KPMG tax personnel to or on behalf of customers of a client company where the fees are paid to KPMG directly by the client company. These services may be considered alliances and would be subject to the specific alliance approval requirements set forth in this chapter.

52.2 General

52.2.1 An *alliance* is broadly defined as a business relationship between KPMG and an outside firm in which the parties intend to work together for more than a single transaction (engagement) or series of related transactions. In the case of a tax solution or strategy, an *alliance* is generally a continuing relationship with another firm to develop, market or deliver the solution or strategy.

52.2.2 The alliance may be with another firm (such as a law firm) to jointly serve our clients, with a company (such as a bank) to serve its customers, with an investment banking firm to implement financial aspects of a solution or strategy, with a software company in connection with software implementation to support a solution or strategy, or any other continuing relationship with another firm relating to developing, marketing or delivery of a solution or strategy.

52.2.3 Generally, only a partner may initiate discussions for consideration of an alliance. No partner, however, may commit the firm to any alliance without following the approval process discussed below. KPMG's primary goal should be to emerge from the alliance in a more competitive position, having received financial or other benefits. It is important, therefore, that appropriate due diligence is performed and approvals obtained prior to linking our name, or doing business, with another firm. In addition to the professional practice considerations discussed in paragraph 52.3.1 of this chapter, the quality of the alliance partner, the terms and conditions of the alliance, and quality of the product and/or service to be provided by the alliance partner are among the considerations taken into account in evaluating a prospective alliance partner.

52.2.4 There are Level 1 and Level 2 alliances. For tax solutions and services, both types require the approval of the vice chairman—tax services and the partner in charge of the Department of Professional Practice—Tax. A Level 2 alliance also must be approved by the Management Committee. We generally do not enter into alliances (Level 1 or Level 2) with SEC audit clients.

52.3 Professional Practice Considerations

52.3.1 There are special approval requirements for alliances, because of:

Association risk: This is the risk that the firm's reputation or resources will be adversely affected by the affiliation with the other firm (e.g., if the client sues us for a strategy that does not succeed on account of the other firm).

Independence risk: This is the risk that our objectivity may be impaired or appear to be impaired by aligning with an audit client (public or nonpublic) or with a person in a position of significant influence over a public audit client.

Fee arrangement risk: This is the risk that the fee arrangement will violate federal or state prohibitions on *fee splitting*, or on paying or receiving commissions or referral fees. Although AICPA Rule 503 generally permits commissions and referral fees for non-audit clients, many states prohibit them for both audit and non-audit clients.

Conflict of interest risk: This is the risk that teaming with another firm may conflict or appear to conflict with the interests of clients that are competitors of the other firm.

52.4 Level 1 versus Level 2 Alliances

52.4.1 Level 2 Alliances

A *Level 2 alliance* is an arrangement that has any or all of the following conditions:

An exclusive arrangement: That is, KPMG would be precluded from marketing or delivering similar solutions or services with anyone else.

Public marketing of the alliance: For example, the alliance would be advertised in *The Wall Street Journal* or described in marketing brochures.

Financial commitment by KPMG: That is, KPMG would be required to make a financial commitment or equity investment as a condition of the alliance relationship.

52.4.2 Level 1 Alliances

Alliances that are not considered Level 2 alliances are *Level 1 alliances*. Consequently, an exclusive agreement to jointly market a *specific* tax solution or service (as opposed to *similar* solutions) would generally be considered a Level 1 alliance. Similarly, Level 1 alliances generally include agreements with other firms that do not involve public marketing or otherwise require financial commitments by KPMG.

52.4.3 Examples of Alliances

The examples below provide guidance on when an arrangement is an alliance and on the distinction between a Level 1 and Level 2 alliance. These examples are not intended to be an all-inclusive listing of the circumstances where an alliance may or may not exist. As previously discussed in paragraph 52.2.1 of this chapter, an *alliance* is any continuing business relationship with another firm (whether or not evidenced by a written agreement). Firm personnel should consult with the Department of Professional Practice—Tax if there are questions as to whether a particular business relationship with another firm may constitute an alliance.

May 2002

Law Firm Assists in Delivering a Tax Strategy

Example 1—no alliance. KPMG and Law Firm both provide tax services to Client 1. KPMG and Law Firm have informal discussions concerning a tax strategy and subsequently agree that the strategy is sound. KPMG and Law Firm approach Client 1 with the strategy, and Client 1 decides to implement it. KPMG and Law Firm do not intend to jointly market the strategy. KPMG and Law Firm enter into separate engagement letters with Client 1, and there is no fee splitting or referral fees or commissions. The arrangement between KPMG and Law Firm is not an alliance.

Example 2—no alliance. Same facts as in Example 1 and six months later, KPMG determines that the strategy will benefit Client 2. In discussions with Client 2, KPMG explains that a law firm must be involved to help implement certain portions of the strategy. When asked by Client 2 whether KPMG knows of any law firms that understand the strategy, KPMG informs Client 2 that KPMG and Law Firm worked together on a prior transaction. Client 2 hires KPMG and Law Firm to help implement the strategy. KPMG and Law Firm do not intend to jointly market the strategy. KPMG and Law Firm enter into separate engagement letters with Client 2, and there is no fee splitting or referral fees or commissions. The arrangement between KPMG and Law Firm is not an alliance.

Example 3—Level 1 alliance. Same facts as in Examples 1 and 2, and after the strategy has been implemented by Client 2, KPMG and Law Firm enter into an agreement to jointly approach other potential clients with the strategy. The strategy will be marketed as one package, using the services of both KPMG and Law Firm. KPMG and Law Firm agree that neither will market the strategy without the other firm. There will be no public joint marketing activities. However, KPMG and Law Firm conduct seminars discussing the general concepts of the strategy in ten cities. This is a Level 1 alliance. Separate engagement letters still should be used to avoid possible fee splitting and unauthorized practice of law issues.

Example 4—Level 2 alliance. Same as Examples 1 through 3, and after several successful sales of the strategy, KPMG and Law Firm decide to continue the agreement but will also start jointly marketing the strategy by placing ads in *The Wall Street Journal* or distributing a marketing brochure. This is a Level 2 alliance.

Payment of Referral Fees

Example 5—alliance. A regional CPA firm has numerous clients that could be candidates for certain tax solutions offered by KPMG. KPMG agrees with the regional CPA firm that, subject to applicable AICPA and state accountancy rules, KPMG will pay the regional CPA a specified percentage of KPMG's revenues from specified tax strategies delivered to clients referred by that firm. As there is a sharing of revenue with respect to KPMG's delivery of services to the regional CPA firm's clients, this is an alliance.

Bank or Investment Banking Firm Assists in Delivering a Tax Strategy

Example 6—no alliance. KPMG has developed a strategy that requires the use of a “qualified intermediary” (e.g., a bank or investment banking firm). KPMG has discussed the strategy with two or more qualified intermediaries, none of which is a KPMG audit client and each has agreed to assist in implementing the strategy should a client select one of them, provided the client and the qualified intermediary can agree to mutually acceptable terms. KPMG approaches Client with the strategy and a list of qualified intermediaries. Client is free to choose from the qualified intermediaries on the list or to find its own qualified intermediary. None of the qualified intermediaries participates in marketing of the strategy with KPMG, and there is no public notification of a relationship between KPMG and a qualified intermediary. KPMG and the qualified intermediary chosen by the client enter into separate engagement letters with Client, and there is no fee splitting or referral fees or commissions. There is no alliance between KPMG and any of the qualified intermediaries.

Example 7—alliance (exclusive referrals). Same as Example 6, except there is only one qualified intermediary recommended by KPMG or participating in the strategy. The relationship with the qualified intermediary is an alliance. *An alliance may also exist where KPMG is the only service provider recommended by another firm as part of a similar relationship to deliver its products or services.*

Example 8—alliance (“steering”). Same as Example 6, except that KPMG indicates to Client that a particular intermediary’s services are preferable to others on the list or otherwise indicates that KPMG has worked well in the past with a particular service provider (i.e., implying that a particular provider is preferred by KPMG). *An alliance may also exist where another firm, as part of a similar relationship to deliver its products or services, indicates to its customers that there are several firms capable of providing the recommended services but that KPMG’s services are preferred.*

KPMG Assists a Client in Serving the Client’s Customers

Example 9—no alliance. Bank has Customers that might benefit from KPMG’s tax strategies. Some of the strategies require the participation of a third party, which could be Bank. Bank would like to introduce KPMG to Customers in the expectation that Bank would provide services to Customers in the event that KPMG was engaged. There is no alliance if the following conditions are satisfied:

- Bank does not distribute KPMG marketing material to Customer;
- if Customer contacts KPMG, we meet with Customer without Bank personnel present, or it is made clear to Customer that it could use a firm other than KPMG for tax advice or a firm other than Bank for related financial services;
- to the extent third-party involvement is required to implement a strategy, Customer is free to choose someone other than Bank; and
- any engagement letters are entered into separately by Customer with KPMG and with Bank, and there are no referral fees or commissions.

May 2002

If any of the conditions set forth above is not met, KPMG's relationship with Bank would be viewed as an alliance.

If Bank is a KPMG audit client, two additional conditions are to be met in order to avoid independence concerns:

- Bank refers each Customer to at least two other tax advisors in addition to KPMG; and
- Bank does not solely recommend to Customer a strategy that KPMG is offering.

Coalitions

Example 10—no alliance. KPMG forms a coalition with representatives of a given industry relative to proposed legislative or regulatory changes. This is not an alliance.

52.5 Independence Considerations

52.5.1 Chapter 12 of the *RMM—U.S.* describes the standards firm professionals follow in maintaining independence with respect to the firm's audit clients. As further discussed in that section, cooperative business relationships with audit clients generally impair the firm's independence. Cooperative relationships may include but would not necessarily be limited to: joint marketing arrangements; partnerships or joint ventures; sub-contractor/prime contractor relationships; and equity investments.

52.5.2 Alliances with SEC audit clients. The SEC considers independence to be impaired when the firm has a *direct or material indirect* business relationship with an SEC audit client or with persons associated with the client in a decision-making capacity. Accordingly, the firm does not enter into alliances (Level 1 or Level 2) with SEC audit clients or with persons associated with the client in a decision-making capacity. As further discussed in section 52.9 of this chapter, however, the firm may enter into "private label" services with an SEC audit client if the fees for the "private label" services are not material to either the firm or the audit client and approval of the Independence Group in the Department of Professional Practice—Assurance is obtained.

52.5.3 Alliances with non-SEC audit clients. For non-SEC audit clients, the AICPA considers independence to be impaired when the firm has a business relationship with the audit client that is *material* to the firm or the audit client. Generally, materiality to the firm is determined with reference to the expected fees to be derived from the alliance relationship. With respect to the audit client, materiality is generally determined with reference to the expected economic benefits to be derived from the alliance relationship with the firm.

52.6 Concept Development and Approval Process

52.6.1 The sponsoring partner involves a partner or senior manager in the Strategic Alliances & New Ventures practice (SANV) to review a rough business case for the alliance. If it is determined that the proposed alliance may be appropriate for the firm from a

business perspective, and the proposed alliance is approved by the applicable national practice leader (e.g., compensation and benefits, state and local tax services), SANV and the sponsoring partner work together to further develop the business case and structure the appropriate relationship with the proposed alliance partner. Requests for SANV practice involvement are initiated through completion of the Alliance/New Venture Submission Form. An electronic version of the form along with other related tools to assist with evaluating the proposed alliance are available on the SANV homepage at <http://taxkm.us.kworld.kpmg.com/homepages/sanv/index.htm>.

- 52.6.2 SANV will confirm that the proposed alliance partner is not already an alliance partner of the firm. If it is, SANV will facilitate the sponsoring partner's request for information from the sponsoring partner for the existing alliance (or client lead partner, as appropriate) as to the status of any existing relationship with the entity.
- 52.6.3 SANV also completes an initial independence check through the KPMG Independence Compliance System (KICS) to determine whether the proposed alliance partner is an audit client (or an affiliate of an SEC audit client) of the firm. As appropriate, SANV considers other information sources outside of KICS to assess whether an audit relationship may exist with the proposed alliance partner.
- 52.6.4 SANV works with the sponsoring partner to further assess potential independence, conflicts of interest and other professional practice issues to determine if there are risk management issues associated with the proposed alliance. The Department of Professional Practice—Tax is to be consulted with respect to risk management issues that may arise from the proposed alliance. The Department of Professional Practice—Tax will in turn consult with the firm's Office of General Counsel and the Independence Group in the Department of Professional Practice—Assurance, as appropriate.
- 52.6.5 Upon securing approval for the proposed alliance from the applicable national practice leader and completion of their initial evaluation, SANV and the sponsoring partner prepare a business plan for the proposed alliance for further approval by the partner in charge of SANV, and complete the standard documentation for firmwide alliance approval as set forth below.
- 52.7 **Standard Documentation and Final Alliance Approval**
 - 52.7.1 **Level 1 Alliances.** The completed business plan, any draft agreements, and a Prospective Alliance Form (PAF) are developed and are submitted, with any other background materials, to the partner in charge of the Department of Professional Practice—Tax for approval. Upon the Department of Professional Practice—Tax's approval, the PAF and related documents are forwarded to the vice chairman—tax services for final approval. The PAF and background materials then are sent to the Department of Professional Practice—Risk Management Advisory Services for processing. The sponsoring partner then provides relevant information to the Office of General Counsel to assist with drafting or finalizing the alliance agreement(s).

May 2002

- 52.7.2 Level 2 Alliances.** The approval requirements are the same as with a Level 1 alliance, except that the Management Committee also must approve the alliance. Approval generally will be denied unless there is a strong business case for the alliance. The Department of Professional Practice—Risk Management Advisory Services generally coordinates the submittal of the PAF and background materials to the Management Committee.
- 52.7.3 Alliance Renewals.** Careful consideration must be given to the benefits of renewing alliance agreements. All alliance renewal requests must be submitted through a completed PAF.

Customer-directed Tax Services

52.8 General

- 52.8.1** *Customer-directed tax services* are broadly defined as services provided by KPMG tax personnel to or on behalf of customers of a client company where the fees are paid to KPMG directly by the client company (e.g., provision of personal financial planning reports, review of personal insurance policies, provision of survivor counseling services, preparation of individual income tax returns). The term does not include services provided to or on behalf of employees of a client company. Customer-directed tax services may be classified as either “private-label” services or “KPMG-branded” services.

52.9 Private-label Services

- 52.9.1** *Private-label services* exist where KPMG tax personnel provide services to or on behalf of customers of a client company where the service offering is identified as the client company’s service, not as a KPMG service offering. KPMG’s involvement or role is not disclosed to the customer, and any deliverable provided the customer makes no reference to KPMG. KPMG’s fees are paid by the client company. For example, *AcumenTM* is a service where KPMG produces customized personal financial planning reports either on an outsourced basis or by KPMG directly. If the reports are produced on an outsourced basis and the service offering is identified as the client company’s service, it is considered a private-label service. On the other hand, if the service is identified as a KPMG service, then it is considered a branded service as discussed below.
- 52.9.2** KPMG may be engaged by any company to provide private-label services to or on behalf of customers of the company. However, if the company is an SEC audit client, the expected fees for the services cannot be material to the client or to KPMG. Before accepting an engagement to provide private-label services to customers of an SEC audit client, approval from the Independence Group in the Department of Professional Practice—Assurance is required.
- 52.9.3** Contracts and engagement letters for private-label services are approved by the Department of Professional Practice—Tax and, when the client is an SEC audit client, by the Independence Group in the Department of Professional Practice—Assurance.

- 52.9.4** KPMG personnel may not have direct contact with the company's customers.
- 52.10 KPMG-branded Services**
- 52.10.1** *KPMG-branded services* exist where KPMG tax personnel provide services to or on behalf of customers of a client company where the service offering is identified as being provided by KPMG, not the client company. KPMG's fees are paid by the client company.
- 52.10.2** An alliance exists in any case where KPMG personnel provide KPMG-branded services; therefore, KPMG-branded services are not provided to customers of KPMG audit clients.
- 52.10.3** Where a non-audit client's customers include officers, directors or major shareholders of SEC audit clients, services to those customers cannot include any services that would be proscribed if provided directly.
- 52.10.4** Any arrangements to provide KPMG-branded services to or on behalf of customers of a non-audit client are subject to the alliance development and approval process set forth in sections 52.6 and 52.7 of this chapter.

Chapter 53—Use of Subcontractors

53.1 Policies

Subcontracting arrangements entered into with respect to tax engagements are to be approved by the vice chairman—tax operations before the arrangement is agreed to with the subcontractor. If the arrangement is approved, the firm's standard subcontractor agreement is executed.

The firm is prohibited from entering into prime/subcontractor relationship with any publicly held assurance client or other prohibited entity. Subcontractors must undergo background and conflicts checks and, if the subcontractor is a company, an independence check.

53.2 General

- 53.2.1 Subcontracting arrangements entered into with respect to tax engagements are to be approved by the vice chairman—tax operations before the arrangement is agreed to with the subcontractor.
- 53.2.2 Clients generally assume that subcontractors meet the same high standards as KPMG professionals. Therefore, it is essential that all subcontractors be subject to background and conflicts checks.
- 53.2.3 Working with KPMG Consulting, Inc. (KCI) has special requirements as described in PPL 02-021, *Guidance on Services Provided by KPMG LLP and KPMG Consulting, Inc. and Related Requirements*, and Chapter 54 of this manual.

53.3 Definitions of Terms

Subcontractors: Subcontractors are engaged by KPMG to assist in the delivery of a client engagement pursuant to an identifiable engagement letter (i.e., the "prime contract").

Independent Contractors: Independent contractors are engaged by KPMG for internal projects, and not for any specific client engagement. For example, KPMG may engage an experienced tax professional to assist in the review of tax returns during busy season. In these cases, the independent contractor is not being "subbed" against any specific client contract and is being engaged by, and for the benefit of, KPMG. Firm policies with respect to subcontractors *do not apply* to independent contractors.

Individuals versus Companies: To qualify as a "company," the entity must have at least 20 full-time employees.

May 2002

53.4 Subcontractor Companies

53.4.1 The firm is prohibited from entering into a prime/subcontract relationship with any SEC audit client or other prohibited entity. The following procedures are to be followed in order to retain a subcontractor company:

- An independence check on the subcontractor company is completed. Questions regarding the independence considerations should be referred to the Department of Professional Practice—Tax, who will coordinate as needed with the Independence Group in the Department of Professional Practice—Assurance;
- A conflict of interests check for the subcontractor company is completed. A conflict of interests check is arranged through the Compliance Group in the Department of Professional Practice—Assurance, which can be reached through the National Support Center (1-800-KPMG-HELP, selection option 3-Assurance Applications, then option 4-Conflicts Group);
- A background check for the company is completed. The *Request for Background Check—Subcontractor Company* (posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>) is completed by the engagement partner and submitted to KPMG's Risk Management Group. Once submitted, background checks may take two to three weeks to complete. All costs are to be borne by the tax project/engagement;
- In accordance with firm policy, Form W-9 is completed for all vendors of the firm, including subcontractors;
- In addition, the KPMG standard Subcontractor Agreement requires the subcontractor company to conduct background checks on each employee and make such documentation available if requested. If we cannot confirm that such background checks have been conducted, KPMG will independently conduct background checks on the employees who will be working on the engagement, as well as on those individuals who are in a position to influence the financial results reported by the entity (e.g., CEO, CFO);
- The results of the independence, conflict of interests and background checks are submitted to the vice chairman—tax operations for approval, along with a description of the contemplated arrangement; and
- If the vice chairman—tax operations approves the arrangement, the standard Subcontractor Agreement is executed. Each employee of the subcontractor company assigned to an engagement signs a separate "Provider Confirmation Agreement" to the Subcontractor Agreement. Both agreements are posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

53.4.2 The subcontractor company may not begin work on an engagement until all of the procedures above have been completed.

53.5 Individual Subcontractors

53.5.1 The following procedures are followed in order to retain an individual subcontractor:

- A conflict of interests check for the individual is completed. The conflict of interests check is arranged through the Compliance Group in the Department of Professional Practice—Assurance as outlined above;
- A background check for the individual is completed. The background check is arranged using the Form WP-221, *Authorization for Release of Information—Independent Contractor* (posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>). Once submitted, background checks may take two to three weeks to complete. All costs are to be borne by the tax project/engagement;
- In accordance with firm policy, Form W-9 is completed for all vendors of the firm, including subcontractors;
- The results of the background and conflicts of interest checks are submitted to the vice chairman—tax operations for approval, along with a description of the contemplated arrangement; and
- If the vice chairman—tax operations approves the arrangement, the standard Subcontractor Agreement is executed.

53.5.2 Generally, an individual subcontractor should not begin work on a tax engagement until all requirements have been completed. In unusual circumstances, an individual subcontractor may begin work subject to the successful completion of the background and conflicts of interest checks with the approval of the vice chairman—tax operations.

53.6 Teaming Agreements

53.6.1 If a subcontractor is considered critical to the engagement's success, a "Teaming Agreement" (posted on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>) may be executed at the proposal stage of the engagement, after the independence, conflicts and background checks are completed and the vice chairman—tax operations has approved the arrangement. Once the work has been awarded, the Teaming Agreement is replaced by the standard Subcontractor Agreement.

53.7 Master Subcontractor Agreements

53.7.1 Each tax engagement, and each subcontractor on a tax engagement, requires a separate agreement in accordance with the policies above. If it is desirable to enter into *master agreements* with subcontractors that are utilized on multiple engagements, this should be approved through the firm's standard alliance approval process as described in Chapter 52 of this manual.

May 2002

53.8 Technology

- 53.8.1** All subcontractors are to have their own e-mail account outside of the KPMG system. As a general matter, no access to the KPMG network is provided to subcontractors.

53.9 Documentation

- 53.9.1** When using subcontractors, reference should be made in the engagement letter with the client. If there are difficulties or performance issues with the subcontractor, at the conclusion of the tax engagement, the engagement team should submit the name of the subcontractor, along with the name of the tax engagement partner, to the Department of Professional Practice—Tax and the vice chairman—tax operations for future reference.

Chapter 54—Relationship with KPMG Consulting, Inc.

54.1 Policies

KPMG Consulting, Inc. (KCI) and KPMG have entered into a noncompetition agreement regarding the professional services to be provided by each firm and other related matters. In addition, the SEC has issued a no-action letter that places certain restrictions on KPMG. Under the terms of the no-action letter, KPMG is restricted from entering into revenue- or profit-sharing arrangements with KCI. Except for specifically targeted groups of clients, KPMG is restricted from engaging in joint marketing and business development activities with KCI. We may refer clients to each other, but neither firm may receive any referral fees, commissions or other compensation in connection with the referrals.

54.2 General

- 54.2.1** As a result of the separation of KPMG Consulting, Inc. (KCI) from KPMG, the two firms have entered into a noncompetition agreement regarding the professional services to be provided by each and other related matters. In addition, the SEC has issued a no-action letter that places certain restrictions on KPMG. Under the terms of the no-action letter, KPMG is restricted from entering into revenue- or profit-sharing arrangements with KCI. Except for specifically targeted groups of clients, KPMG is restricted from engaging in joint marketing and business development activities with KCI. KPMG and KCI may refer clients to one another, provided neither firm receives any fees in connection with the referrals and KPMG does not designate KCI as a preferred provider of services. See PPL 02-021, *Guidance on Services Provided by KPMG LLP and KPMG Consulting, Inc. and Related Requirements*.
- 54.2.2** The types of services that KPMG and KCI may perform for clients are defined by the noncompetition agreement between the entities. Permitted services depend on the nature of the work, the service offered and existing client relationships.
- 54.2.3** In general, KPMG's performance of tax services for clients is not restricted by the noncompetition agreement between KPMG and KCI.
- 54.2.4** Questions related to the services offered by KPMG or KCI should be discussed with Risk Management—Advisory Services in the Department of Professional Practice—Assurance or with the Department of Professional Practice—Tax.

54.3 Engagements With KCI

- 54.3.1** KPMG is prohibited from entering into revenue- or profit-sharing arrangements with KCI. As such, KPMG is not allowed to receive any royalty, interest or other payment in connection with a client contract. Entering into a joint venture or similar arrangement with KCI is also prohibited.
- 54.3.2** Effective February 2002, KPMG and KCI may enter into certain prime/subcontract arrangements to provide professional services to the same client. Because of the

May 2002

specific restrictions governing KPMG's relationship with KCI, all proposed prime/subcontract arrangements between KPMG and KCI require consultation with the Department of Professional Practice—Risk Management Advisory Services.

- 54.3.3** Confidential information (including client/prospect lists) is not to be communicated between KPMG and KCI. In addition, KPMG may not enter into any separate licensing arrangement with KCI with respect to intellectual property owned by KCI.

54.4 Recruiting

- 54.4.1** KPMG is prohibited from using the term "consultant" in connection with its recruiting efforts.

54.5 Marketing

- 54.5.1** Except for specifically targeted groups of clients, KPMG is prohibited from having co- or joint advertising or marketing arrangements with KCI. Neither KPMG nor KCI may represent that it is the same firm as, or is in any way affiliated with, the other firm. KPMG also may not represent that it controls, manages or governs KCI.

- 54.5.2** KPMG is prohibited from co-sponsoring an event with KCI as the only other substantive sponsor. For further questions regarding marketing efforts with KCI, please contact Brand and Regulatory Compliance at <http://legacy.kworld.kpmg.com/microwebs/us/Marketing/brcguidelines/index.html>.

- 54.5.3** KPMG and KCI may, but are under no obligation to, refer clients to one another; however, in no event are referral fees, commissions or other compensation for such referrals to be paid. KPMG is also prohibited from designating KCI as a preferred provider of services.

Part VI—Dealings With Tax Authorities

In this Part This part contains five chapters:

Chapter	Title
60	Tax Examinations, Tax Protests and Requests for Technical Advice and Ruling Requests
61	Privileges
62	Penalties, Other Sanctions and "9100" Relief
63	Tax-related Litigation Services
64	Tax Legislative Activities

Chapter 60—Tax Examinations, Tax Protests and Requests for Technical Advice and Ruling Requests

60.1	Policies
60.1.1	Federal Examination
	If firm personnel represent a client in connection with a federal tax return examination, request for a ruling or similar matter, a power of attorney granting authority to act in the matter is filed with the Internal Revenue Service.
60.1.2	Power of Attorney
	With very limited exceptions, firm professionals who sign a power of attorney are licensed CPAs, licensed attorneys or enrolled agents.
60.1.3	Tax Protests
	Federal tax protests are sent to the appropriate national technical resource and the appropriate Tax Controversy Services professional for a concurring review prior to submission to the taxing authority. State tax protests are sent to the appropriate state and local tax national technical resource for concurring review prior to submission.
60.1.4	Request for Technical Advice and Ruling Requests
	Requests for technical advice and ruling requests are forwarded to Washington National Tax for review and filing with the Internal Revenue Service National Office.
60.1.5	Tax Controversy Services Practice
	Firm personnel are required to involve the Tax Controversy Services practice on significant IRS controversy engagements.

60.2 Treasury Department Circular 230

- 60.2.1** Treasury Department Circular 230 contains rules governing the practice of attorneys, certified public accountants and enrolled agents before the IRS. These rules provide guidance on the duties and restrictions relating to practice before the IRS and rules applicable to disciplinary proceedings. Treasury Department Circular 230 is reproduced in most major federal income tax services (*CCH Standard Federal Tax Reporter*, *RIA United States Tax Reporter* and others) and can be found on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

May 2002

Powers of Attorney and Tax Information Authorizations**60.3 General**

60.3.1 If firm personnel represent a client on a federal tax return examination, request for a ruling or similar matter, a power of attorney (IRS Form 2848) granting authority to act in the matter shall be filed with the IRS. A tax information authorization (IRS Form 8821) may be used to grant us access to confidential tax information, notices and other written communications. Since this type of authorization allows us only to receive information, however, its use is limited.

60.3.2 For more detailed coverage of these requirements and the standard forms used, see the Treasury Regulations in the IRS "Statement of Procedural Rules" at Part 601, Title 26, of the Code of Federal Regulations.

60.3.3 The guidance set forth in this chapter also generally applies to powers of attorney granted with respect to state tax matters. However, the applicable state laws with respect to powers of attorney should be consulted as each state promulgates its own rules and procedures.

60.4 Tax Matters Covered

60.4.1 By its nature, a power of attorney granted with respect to a specific transaction is limited in time to the period required to accomplish the transaction, which often is difficult to determine in advance. The IRS, therefore, has informally stated that, so long as a power fully describes the specific transaction and thereby places a definite limitation on the power, that power need not specify a time period during which it is effective.

60.5 Authority To Sign

60.5.1 It is important that the individual who signs the power or authorization has the authority to do so. Generally, a power of attorney or tax information authorization may be signed only by a licensed CPA, licensed attorney or enrolled agent. An unenrolled return preparer may sign a power of attorney to represent a taxpayer in an examination of a return the individual signed as preparer (but not to represent the taxpayer in an appeal of the results of the IRS exam).

60.6 Agent's Examination

60.6.1 A discussion of IRS' examination of accountants' work papers is set forth in Chapter 50 of this manual.

60.6.2 Acceptance forms (Form 870 or Form 870-AD) are signed by the client even if firm personnel have been granted authority to act in the matter on behalf of the client in a power of attorney. This form documents the client's acknowledgment and acceptance of the terms of the settlement.

- 60.6.3** See section 60.17 of this chapter for required involvement of the Tax Controversy Services practice in significant IRS controversy engagements.
- 60.6.4** Guidance on handling potential tax fraud cases is set forth in Chapter 63 of this manual.
- 60.7 Federal Tax Protests**
- 60.7.1** See Rev. Proc. 2002-1, 2002-1 I.R.B. 1 (or the corresponding successor annual revenue procedure) for guidance on federal tax protests. See IRS Publication 5, *Appeals Rights and Preparation of Protests for Unagreed Cases*, for instructions and procedures in connection with a taxpayer's right of appeal and protest.
- 60.7.2** Before filing, federal protests are sent to the appropriate national technical resource and to the appropriate Tax Controversy Services professional for a concurring review.
- 60.7.3** Appendix A contains a form to be used to transmit the protest for concurring review.
- 60.8 Involvement of Legal Counsel**
- 60.8.1** In cases involving issues that ultimately may proceed to litigation, firm personnel exercise judgment in deciding whether, and at what stage of the appeal process, to recommend to a client that legal counsel also be retained.
- 60.8.2** If such litigation is anticipated, legal counsel ordinarily is retained by the client during the process of preparing a written protest to be filed with the appropriate appeals office. In such a case, it is recommended that legal counsel review the protest before it is filed.
- 60.9 State and Local Tax Protests**
- 60.9.1** As appropriate, state and local tax protests are sent to the appropriate national technical resource for state and local tax for a concurring review before the protest is filed with the authorities.

Requests for Rulings

60.10 General

- 60.10.1** IRS policy in connection with the issuance of rulings is set forth in Revenue Procedure 2002-1, 2002-1 I.R.B. 1 (or the corresponding successor annual revenue procedure). This revenue procedure contains instructions as to the nature of facts to be submitted in a ruling request. A ruling request must analyze all material facts and state the taxpayer's views as to the tax results of the proposed action and the relevant authorities supporting such views.
- 60.10.2** See section 60.15 of this chapter for certain procedures for filing ruling requests.

May 2002

60.11 Advance Ruling Requests

- 60.11.1** If a client requests the firm's advice on the tax effects of a proposed transaction, the advisability of requesting an advance ruling from the IRS National Office is considered, particularly if the amount of the potential tax liability is substantial and the client is willing to wait until the ruling has been secured before completing the transaction. The client is advised of the procedure for obtaining advance rulings from the government.

60.12 Determination Letters

- 60.12.1** Revenue Procedure 2002-1 (or the corresponding successor annual revenue procedure) describes a determination letter as a "written statement issued by a director that applies the principles and precedents previously announced by the national office to a specific set of facts." Determination letters are issued only if published authority exists to resolve the questions presented. An unusual fact pattern or novel issue ordinarily precludes a director from issuing a determination letter.
- 60.12.2** Section 7 of Revenue Procedure 2002-1 gives further guidance regarding circumstances in which a director will consider issuing a determination letter.
- 60.12.3** Most requests for determination letters involve routine matters and thus do not require concurring review by personnel in Washington National Tax.

60.13 Technical Advice

- 60.13.1** IRS policy in connection with a request for technical advice is set forth in Revenue Procedure 2002-2, 2002-2 I.R.B. 82 (or the corresponding successor annual revenue procedure). A request for technical advice results from a controversy in an IRS examination of the taxpayer's return or refund claim. A request for technical advice may be made by a director or area director, appeals. A taxpayer may request that the issue be referred to the national office for technical advice but may not request the advice directly.
- 60.13.2** Although there is no prescribed form or content for a request for technical advice, it is advisable to follow the format outlined for a request for ruling as discussed in Revenue Procedure 2002-1 (or the corresponding successor annual revenue procedure).
- 60.13.3** Requests for technical advice, whether initiated by the taxpayer or the IRS, are forwarded to WNT for review and filing.
- 60.13.4** A technical advice memorandum issued by the IRS National Office is forwarded directly to the director or area director, appeals who then issues a copy to the taxpayer. To complete the client's file, the operating location forwards a copy of the technical advice to WNT.

60.14 Competent Authority Requests

- 60.14.1** IRS policy in connection with the issuance of a competent authority request is set forth in Revenue Procedure 1996-13, 1996-13 I.R.B. 31, as such authority may be updated from time to time. This revenue procedure sets forth the procedures concerning requests by taxpayers for assistance of the U.S. competent authority under the provisions of an income, estate or gift tax treaty to which the United States is a party.
- 60.14.2** The procedures for filing competent authority requests are similar to those for filing ruling requests. See section 60.15 of this chapter for procedures for filing ruling requests.

60.15 Coordination With Washington National Tax

- 60.15.1** Through contacts in the IRS National Office, WNT personnel know the agency's policies and positions and can assist clients seeking prompt action on ruling requests. Accordingly, all ruling requests (including exhibits) are forwarded to WNT for concurring review and filing with the IRS National Office. WNT responds to the initiating location by e-mail or telephone not later than the day following receipt of the draft ruling request.
- 60.15.2** After the WNT review is completed and the request is revised as necessary, the initiating location either finalizes the request and forwards it to WNT for filing, or asks that WNT finalize and then file the request. In the latter case, WNT sends a copy of the final request to the initiating location for its file and for delivery to the client.
- 60.15.3** Washington National Tax also can prepare a ruling request. The requesting location is to furnish all relevant information. WNT attempts to complete requests within one week of receipt of the information and provides copies to the initiating location for approval before filing the original with the IRS.
- 60.15.4** A power of attorney is filed with the IRS National Office if the firm requests a ruling on behalf of a client. If we are acting under the authority of a power of attorney previously granted by the client, an original signed power of attorney is filed with the ruling request, even if a copy already is on file with an IRS field office or was filed with the IRS National Office in connection with a prior ruling request.
- 60.15.5** Since ruling requests are reviewed and filed by Washington National Tax, WNT personnel generally sign the representation portion of the power of attorney before filing the ruling request with the IRS National Office.
- 60.15.6** Ordinarily, powers of attorney expressly provide that rulings be addressed to individuals in the firm in order that:
- we will know when the ruling is mailed; and
 - we can assess the adequacy of the ruling before passing it on to the client.

May 2002

- 60.15.7** The power of attorney form (IRS Form 2848) contains a box for the taxpayer to check authorizing the taxpayer's representative to receive the original ruling. The party to whom the ruling is requested to be addressed is to be one of the representatives named in the power of attorney, not the firm. Because WNT personnel file the ruling with the IRS National Office, the partner in WNT responsible for the ruling should generally be the representative so named in the power of attorney. If powers of attorney are obtained from more than one taxpayer and filed in connection with a single ruling request, all powers of attorney are to direct that the ruling be addressed to the same individual.
- 60.15.8** If it is desired or required that the ruling be addressed to the client, the power of attorney directs that a copy of the ruling be sent to the partner in WNT responsible for the ruling, who promptly advises the originating location when the ruling has been received and forwards a copy to that location.
- 60.15.9** Since requests that copies be furnished to several persons place an unnecessary burden on the ruling process, the IRS gives copies to no more than two representatives and provides two copies only if those representatives have different mailing addresses. If we are cooperating with a law firm in requesting the ruling, we may need to request that copies be sent to additional persons.
- 60.16 Transmittal of Financial Information to the Taxing Authorities**
- 60.16.1** In preparing a request for an IRS ruling, or in submitting other data to federal and state taxing authorities, we may need to submit a balance sheet, either the one nearest the date of a completed transaction or the most recent one for a prospective transaction. A balance sheet submitted solely to the IRS or other federal or state taxing authorities is not to be labeled or bear a legend to the effect that it is either compiled, reviewed or audited.
- 60.16.2** If a compiled or reviewed balance sheet is submitted to an attorney, or any other party, solely for inclusion in a submission to the taxing authorities, the transmittal letter to such person contains standard disclaimer paragraphs such as:

We have not audited the balance sheet included in the request for ruling. Therefore, we are unable to and do not express any opinion on the unaudited balance sheet as of (date).

The balance sheet included in the request for ruling does not include all disclosures required for a fair presentation in conformity with generally accepted accounting principles. For full disclosure, the balance sheet should be read in conjunction with the financial statements and accompanying notes of (name of client) as of and for the year ended (date), along with our accountants' report dated (date).

- 60.16.3** If an audited balance sheet is submitted to an attorney or any other party, the transmittal letter to such person contains language such as:

The balance sheet included in the request for ruling does not include all disclosure required for a fair presentation in conformity with generally accepted accounting principles. For full disclosure, the balance sheet should be read in conjunction with the financial statements and accompanying notes of (name of client) as of and for the year ended (date), along with our auditors' report dated (date).

60.17 Tax Controversy Services Practice

- 60.17.1** In order to bring the appropriate resources to bear on significant IRS examination engagements (e.g., high-dollar/high-profile engagements), firm personnel are required to involve the Tax Controversy Services practice on significant IRS controversies engagements. This involvement will help the engagement team provide our significant IRS controversy engagement clients with up-to-date information and firmwide experience in strategy formulation, negotiation options and settlement evaluation.

- 60.17.2** Firm personnel representing clients in an IRS tax controversy promptly contact the Tax Controversy Services group where:

- the client is subject to the IRS' Coordinated Examination Program;
- the client is a national account of the firm;
- the client is a high-profile client (e.g., celebrities, politicians); or
- the controversy fees are expected to exceed \$50,000.

- 60.17.3** For these significant IRS tax controversies, firm personnel should provide the appropriate Tax Controversy Services professional with the following information via e-mail:

- name of the client;
- why the exam is considered significant (e.g., fees in excess of \$50,000);
- nature of the controversy; and
- the stage of the controversy (e.g., audit just beginning).

- 60.17.4** The federal services tax partner or tax managing director for the client and the appropriate Tax Controversy Services professional jointly will determine the degree of involvement by Tax Controversy Services personnel in the particular circumstances.

Chapter 61—Privileges

61.1 Policies

We do not provide assurances to a client or its counsel that the attorney-client or federal confidential communications privilege will apply, but act to preserve the confidentiality of communications that may be privileged. In the case of an audit client, our engagement letter or a supplemental letter grants us the right to communicate privileged information among KPMG tax and audit personnel and to use such information in performing the audit, to the extent required by professional standards. Engagements with the client's counsel grant us reasonable access to work papers if any investigation, suit or claim against us arises as a result of the engagement. Firm personnel do not advise clients regarding the applicability of the attorney-client privilege. The client must obtain this advice from its attorney.

61.2 General

61.2.1 We do not provide assurances to a client or its counsel that the attorney-client or federal confidential communications privilege will apply, but act to preserve the confidentiality of communications that may be privileged.

61.2.2 Professional standards may require that information subject to the attorney-client or federal confidential communications privilege be used in auditing a client's financial statements or discussed between firm personnel providing audit services and those providing non-audit services, such as tax services. In the case of an audit client, the engagement letter or supplemental letter explicitly authorizes us to do so.

61.3 Attorney-Client Privilege

61.3.1 Where our advice to a client may involve sensitive issues, the client may wish to consider whether it is possible and appropriate for the advice to be protected from disclosure by the attorney-client privilege. The attorney-client privilege protects the confidential nature of communications between the attorney and the client who is seeking legal advice. To preserve the privilege, the communication must be made in confidence for the purpose of the client obtaining legal advice from the attorney or at the direction of the attorney through the attorney's agents (including ourselves) and the confidence must be maintained.

61.3.2 The attorney-work product privilege is not limited to the work product of an attorney, but also may include, in certain instances, the work performed or prepared by accountants and other advisors in anticipation of litigation.

61.3.3 Before entering into a tax services engagement with a client's attorney, it may be appropriate to consult with the Department of Professional Practice—Tax or the Office of General Counsel.

61.3.4 The responsibility for establishing and maintaining the attorney-client privilege or the attorney-work product privilege is that of the client and the client's counsel. Firm

May 2002

personnel do not advise clients regarding the applicability of the attorney-client privilege. The client must obtain this advice from its attorney. There are standard letters for engagements by a client's outside or inside counsel on the Department of Professional Practice—Tax homepage at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

61.3.5 An attorney may engage us in connection with services provided to the attorney's client in connection with potential fraud cases. Such engagements shall not be undertaken without consultation with the firm's Office of General Counsel and the Department of Professional Practice—Tax. Additional guidance on handling potential fraud cases is set forth in Chapter 63 of this manual.

61.3.6 Although engagements by the client's counsel ordinarily provide that work papers generated during the engagement are the property of the attorney, the engagement agreement is required to provide the firm reasonable protection or access to the work papers if any investigation, suit or claim against us arises as a result of the engagement. In order to protect the firm, although the engagement letter may provide that the client's attorney is the owner of the work papers, the firm has a reasonable right of access to protect itself and its personnel in the event of an investigation, claim or suit.

61.4 Federal Confidential Communications Privilege (IRC Section 7525)

61.4.1 IRC Section 7525 generally provides a privilege, similar to the attorney-client privilege, for certain confidential communications between taxpayers and federally authorized tax practitioners relating to federal tax advice in noncriminal tax matters either before the IRS or in a federal court. The privilege does not apply to written communications between a federally authorized tax practitioner and a corporation or its representative relating to the promotion of the corporation's participation in a tax shelter. For purposes of this exception to the privilege, a *tax shelter* is defined in IRC Section 6662(d)(2)(C)(iii) (i.e., a *tax shelter* is any entity, plan or arrangement with a significant purpose to avoid or evade federal income tax). Although IRC Section 7525 may provide certain defenses to a client that is asked to disclose information to the IRS, the firm does not affirmatively market the privilege to its clients or promise them that this statute will protect them.

61.4.2 As appropriate, the following steps may assist in establishing and maintaining the federal confidential communications privilege:

- written and oral communications between the client and the engagement team are kept strictly confidential and not disclosed to any third parties (Our usual policies and guidance on quality control and review of technical advice are followed, and the communication is submitted to the Tax Knowledge Inbox, but it is not made available to others in the firm who are not involved in the engagement until the communication has been redacted to delete identifying information.);
- correspondence between the client and KPMG, written advice we provide to the client and sensitive documentation relating to the tax advice (such as a memorandum to the file) that may not be provided to the client are labeled

“Private and confidential” (or with words to a similar effect) and are accessible only by the engagement team; and

- our engagement letter is signed or approved by a federally authorized tax practitioner (an attorney, CPA or enrolled agent). If we need to retain outside consultants, there is a separate engagement letter for this service indicating that the consultants are working under the direction and control of a federally authorized tax practitioner in our firm.

61.4.3 As the protection afforded by the federal confidential communications privilege may be limited, the client may wish to consider whether the engagement may be performed in such a manner that the attorney-client privilege may apply.

Chapter 62—Penalties, Other Sanctions and “9100” Relief

62.1 Policies

62.1.1 Penalties and Other Sanctions Against Practitioners

A suggestion by an IRS or state revenue agent, or by other means, that a penalty may be or has been assessed against a KPMG partner or employee requires prompt notification of the tax services engagement partner or tax managing director, who then promptly notifies the firm's Office of General Counsel and the partner in charge of the Department of Professional Practice—Tax.

We consider the potential for Sections 6694 and 6695 return preparer penalties in the delivery of all tax services.

We consider the potential for IRC Section 6701 penalties for aiding and abetting an understatement of tax liability in the delivery of all tax services.

We consider the potential for the following penalties with respect to tax shelters: IRC Section 6700 penalties for promoting abusive tax shelters; IRC Section 6707(a) penalties for the failure to register a tax shelter; IRC Section 6707(b)(1) penalties for the failure to furnish a shelter's tax identification number to the investor; IRC Section 6707(b)(2) penalties for the failure to include the shelter's tax identification number on the investor's income tax return; and IRC Section 6708 penalties for the failure to maintain an investor list.

62.1.2 Penalties Against Taxpayers

As appropriate, we advise clients of the potential penalty consequences of a tax return position and of opportunities to avoid such penalties through disclosure, whether the underlying advice is given orally or in writing.

Tax professionals consult the business unit professional practice partner—tax for approval prior to agreeing to reimburse (directly or through a reduction in fees) a client for taxpayer penalties (or interest) assessed against the client as a result of the firm's error or delay. Generally, reimbursement of interest will not be approved. In no case, does the firm pay taxpayer penalties (or interest) directly to the Internal Revenue Service or any other taxing authority.

The business unit professional practice partner—tax is to approve any correspondence sent to a taxing authority asking for relief from penalties where there is a reasonable possibility the client might hold KPMG responsible for the penalty.

May 2002

62.1.3 “9100” Relief for Missed Elections

Elections made or considered are discussed with the client and are documented in the firm’s computer-based elections checklist, *KPMG/Elections*.

The WNT Tax Controversy Services group reviews requests for relief under Regulation Section 301.9100-1 before submission to the National Office of the Internal Revenue Service. The reviewer’s name is added to the power of attorney included in the submission. In no case is the firm to directly pay, to the Internal Revenue Service, a client’s filing fee for a “9100” relief request. The reimbursement of such filing fee to the client is approved, in appropriate circumstances and under specified conditions, by the Office of General Counsel.

Penalties and Other Sanctions Against Practitioners**62.2 General**

62.2.1 Any penalty asserted against KPMG personnel, regardless of amount, may have serious consequences. If a penalty is assessed against an individual practicing before the IRS or a state department of revenue, the matter may be brought to the attention of the IRS Director of Practice or the state director of revenue. The Director of Practice or state director of revenue may take additional action against the practitioner, such as reprimanding the practitioner or suspending or disbarring the practitioner from practice before the IRS or state department of revenue.

62.2.2 Any suggestion by an IRS or state revenue agent, or by other means, that any penalty may be or has been assessed against any KPMG partner or employee requires prompt notification of the tax services engagement partner or tax managing director, who then promptly notifies the firm’s Office of General Counsel and the partner in charge of the Department of Professional Practice—Tax. This includes a request by the IRS or state department of revenue that the preparer consent to an extension of the statute of limitations regarding a preparer penalty.

62.2.3 As appropriate, the firm defends a partner or employee against the assertion of a penalty and assists in the resolution of the matter. If the individual concedes to any penalty, no matter how small, it could seriously impair the firm’s ability to defend the individual. Therefore, no tax personnel concedes to any penalty without involving the Office of General Counsel and the Department of Professional Practice—Tax. In the unlikely event that a penalty ultimately is sustained, reimbursement for the penalty usually will be made if the individual has followed firm policies.

62.3 Return Preparer Penalties

- 62.3.1** The IRS may propose penalties under Section 6694 of the Code against a preparer if:
- there is an understatement of the taxpayer’s income tax liability due to a position for which there was not a realistic possibility of its being sustained on its merits;

- the preparer knew (or reasonably should have known) of such position; and
- such position was not adequately disclosed or was frivolous.

Increased penalties apply to a willful understatement of liability or reckless or intentional disregard of rules or regulations.

- 62.3.2** Section 6695 of the Code also provides penalties for income tax return preparers, including penalties for failure to sign the return, failure to furnish the taxpayer with a copy of the return, failure to furnish an identifying number and others.

62.4 Penalties for Aiding and Abetting an Understatement of Tax Liability

- 62.4.1** The IRS may propose penalties under Section 6701 of the Code on any person who:

- aids or assists in, procures or advises with respect to the preparation or presentation of a tax return, claim or other document;
- knows (or has reason to believe) that a portion of the tax return or document will be used in connection with any material matter arising under the tax law; and
- knows that a portion of the tax return or other document would result in an understatement of tax liability of another person.

The penalty is \$10,000 for each document relating to a taxpayer for each taxable period if the aiding and abetting involves the tax liability of a corporation, or \$1,000 for each such document in all other cases.

62.5 Penalties for Failing To Register a Tax Shelter or Furnish the Shelter Identification Number

- 62.5.1** The IRS may propose penalties under Section 6707 of the Code for failure to timely or properly register with the Internal Revenue Service two types of *tax shelters* as defined in Sections 6111(c) and 6111(d) of the Code. These penalties generally apply to the person principally responsible for organizing the shelter, but may apply to others if the principal organizer fails to register. Registration is required by the day the shelter is first offered for sale.

- A *Section 6111(c) tax shelter* is any investment with respect to which any person could reasonably infer from the representations made, or to be made, in connection with the offering for sale of interests in the investment, that the tax shelter ratio for any investor as of the close of any of the first five years ending after the date on which the investment is offered for sale may be greater than 2 to 1. The investment also must be required to be registered under a federal or state law regulating securities, sold pursuant to an exemption from registration requiring the filing of a notice, or be a substantial investment. The penalty for failing to register is the greater of one percent of the aggregate amount invested in the shelter, or \$500.

May 2002

- A *Section 6111(d) tax shelter* is any entity, plan, arrangement or transaction: (a) where a significant purpose of the structure of which is to avoid or evade federal income tax for a direct or indirect corporate participant; (b) that is offered to any potential participant under conditions of confidentiality; and (c) for which the tax shelter promoters may receive fees in excess of \$100,000 in the aggregate. The penalty for failing to register is the greater of 50 percent of the fees paid to all promoters of the shelter with respect to offerings made before the date the shelter is registered (75 percent if the failure is intentional), or \$10,000.

A person that sells or otherwise transfers an interest in a Section 6111 tax shelter must provide the tax shelter identification number to each investor in the shelter. The IRS may impose a penalty on the seller or transferor under Section 6701(b)(1) of the Code for the failure to provide the tax shelter identification number to each investor (\$100 per failure).

Note: To further our compliance with the tax shelter registration rules, firm personnel are to:

- obtain certain approvals of the WNT Tax Controversy Services group for opinions on these rules (see Chapter 41 of this manual);
- not enter into certain confidentiality or exclusivity agreements (additional guidance is set forth in Chapter 35 of this manual); and
- include certain “permission to disclose” language on initial client visit and other letters (additional guidance is set forth in Chapter 35 of this manual).

62.6 Penalties for Failing To Maintain a List of Tax Shelter Investors

- 62.6.1** The IRS may impose penalties under Section 6708 of the Code for failure to maintain a list of investors and retain certain documents for arrangements that are considered tax shelters under Section 6112 of the Code. *Tax shelters* for this purpose includes not only shelters that are subject to registration, but other arrangements that the IRS has determined to have tax avoidance potential. The penalty generally applies to the principal organizer of a tax shelter. The penalty is \$50 per investor (\$100,000 per shelter per calendar year).

Note: To further compliance with the tax shelter investor list rules, firm personnel are to submit an Engagement Information Form (EIF) for certain tax services engagements (see Chapter 36 of this manual).

62.7 Penalties for Promoting Abusive Tax Shelters

- 62.7.1** The IRS may propose a penalty under Section 6700 of the Code on any person who:
- organizes (or assists in organizing) a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, or who participates directly or indirectly in the sale of any interest in any such entity or plan or arrangement; and

- makes or furnishes or causes another person to make or furnish either a statement with respect to a tax benefit that the person knows or has reason to know is false or fraudulent as to any material matter, or a gross valuation overstatement as to any material matter.

The penalty is \$1,000 for each activity promoted or, if the person establishes that it is less, 100 percent of the gross income derived (or to be derived) by the person from the activity.

62.8 Sanctions Under Treasury Department Circular 230

- 62.8.1** The IRS office of the Director of Practice may discipline a practitioner for violating standards of conduct set forth in Treasury Department Circular 230, a U.S. Treasury Department regulation governing practice of CPAs, attorneys, enrolled agents and enrolled actuaries before the IRS. Treasury Department Circular 230 provides standards in such areas as preparing returns, drafting opinion letters and avoiding conflicts of interest. Sanctions for violating the Circular include suspension or disbarment from practice before the IRS.

Penalties Against Taxpayers

62.9 General

- 62.9.1** As appropriate, we advise clients of the potential penalty consequences of a tax return position and of opportunities to avoid such penalties through disclosure, whether the underlying advice is given orally or in writing. Treasury Department Circular 230 requires us to inform the client of penalties *reasonably likely to apply* to a tax return position. It also requires us to inform the client of any opportunity to avoid a penalty by disclosure and the requirements for adequate disclosure. The potential penalty consequences, as discussed with the client, are documented for the files.

62.10 Accuracy-related Penalty

- 62.10.1** The accuracy-related penalty under Section 6662 of the Code may be imposed against a taxpayer if there is an underpayment of tax and the underpayment is due to one or more of the types of misconduct listed in that section. The penalty conduct includes negligence or disregard of rules or regulations, and a substantial understatement of income tax. The penalty generally equals 20 percent of the portion of the underpayment due to the misconduct.
- 62.10.2** The accuracy-related penalty is discussed with the client whether the underlying advice is given orally or in writing. The potential penalty consequences, as discussed with the client, are documented for the files.
- 62.10.3** Even though an underpayment of tax may be due to one of the types of misconduct listed in IRC Section 6662, the accuracy-related penalty may not be sustained if the taxpayer establishes that the underpayment was due to reasonable cause and that the taxpayer acted in good faith. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account

May 2002

all pertinent facts and circumstances. The regulations state that a taxpayer's reliance on the advice of a tax professional will constitute reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith.

For example, in order for an opinion letter to provide a basis for reasonable cause relief, the opinion is based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances, and is not based on unreasonable factual or legal assumptions.

In circumstances in which the IRS has asserted or is considering asserting an accuracy-related penalty under IRC Section 6662, consultation with the Tax Controversy Services practice generally will be appropriate.

- 62.10.4 The *substantial understatement* component of the Section 6662 accuracy-related penalty distinguishes between return positions that are attributable to tax shelters and those that are not. For this purpose, a *tax shelter* is any entity, investment, plan or arrangement with a *significant purpose* of avoiding or evading federal income tax. For tax shelter items, we evaluate whether we can opine to the client that the tax treatment of the items is *more likely than not* the proper treatment. Special reasonable cause rules apply in the case of corporate tax shelter opinions.
- 62.10.5 The Internal Revenue Service has stated that the failure by a corporation to disclose a "reportable transaction" under Temporary Treasury Regulation 1.6011-4T may undercut the taxpayer's argument that it qualified for the reasonable cause and good faith exception to the accuracy-related penalty.
- 62.11 **Penalty for Failing To Include a Tax Shelter Identification Number on a Tax Return**
 - 62.11.1 An investor in a Section 6112 tax shelter must include the shelter identification number on its tax return for each year the investor claims a tax benefit from the shelter. IRC Section 6707(b)(2) imposes a penalty on the investor of \$250 per failure.
- 62.12 **Firm Payment of Taxpayer Penalties on Behalf of a Client**
 - 62.12.1 Tax professionals consult with their business unit professional practice partner—tax for approval prior to agreeing to reimburse (directly or through a reduction in fees) a client for taxpayer penalties (or interest) assessed against the client as a result of the firm's error or delay. Generally, reimbursement of interest will not be approved. In no case does the firm pay taxpayer penalties (or interest) directly to the Internal Revenue Service or any other taxing authority.
 - 62.12.2 The business unit professional practice partner—tax is to approve any correspondence sent to a taxing authority asking for relief from penalties where there is a reasonable possibility the client might hold KPMG responsible for the penalty.

62.13 "9100" Relief for Missed Elections

- 62.13.1** The complexities of the U.S. tax system may cause missed deadlines for filing elections and applications. If the relevant statute specifies the time filing requirements, there usually is no relief available. Treasury Regulation Sections 301.9100-1 and 301.9100-2(b) discuss limited circumstances in which relief is available for elections with a due date prescribed by statute.
- 62.13.2** If the time filing requirements are delegated to the IRS to prescribe by regulation or by a revenue ruling, revenue procedure, notice or an announcement published in the Internal Revenue Bulletin, relief may be sought under Treasury Regulation Sections 301.9100-1, 301.9100-2 and 301.9100-3. The annual revenue procedure applicable to letter rulings, determination letters and other IRS rulings provides further reference. See, for example, Revenue Procedure 2002-1, 2002-1 I.R.B. 1 (or the corresponding successor annual revenue procedure).
- 62.13.3** The WNT Tax Controversy Services group reviews requests for Treasury Regulation Section 301.9100-1 relief before submission to the IRS National Office. The reviewer is added to the power of attorney included in the submission to facilitate any contacts with the IRS.
- 62.13.4** In no case is the firm to directly pay, to the Internal Revenue Service, a client's filing fee for a 9100 relief request. The reimbursement of such filing fee to the client is approved, in appropriate circumstances and under specified conditions, by the Office of General Counsel.

Chapter 63—Tax-related Litigation Services

63.1 Policies

63.1.1 Tax-related Litigation Services

All tax-related litigation services are approved by the partner in charge of the Department of Professional Practice—Tax, and the Office of General Counsel is consulted when appropriate.

63.1.2 Practice Before the Tax Court

Only designated Tax Controversy Services professionals may sign or file Tax Court petitions or appear before the Tax Court on a client's behalf and, usually, only if the amount in dispute is significant. Any exception to the above policy is approved by the Office of General Counsel, in addition to the partner in charge of the Department of Professional Practice—Tax. Firm personnel do not prepare petitions for a client's or legal counsel's signature. We do not represent any SEC registrant, any subsidiary or affiliate of an SEC registrant, or any officer or director of an SEC registrant (including any subsidiary or affiliate thereof) before the Tax Court, where the firm is, or is expected to become, the auditor of the SEC registrant.

63.1.3 Handling Potential Fraud Cases

Engagements that involve a potential tax fraud investigation are not undertaken without consultation with the firm's Office of General Counsel and the partner in charge of the Department of Professional Practice—Tax.

The tax services engagement partner or tax managing director promptly informs the partner in charge of the Department of Professional Practice—Tax and the Office of General Counsel of any client involved in a fraud investigation.

63.2 General

63.2.1 Tax-related litigation services include litigation support services: (a) involving actual or expected noncriminal litigation where the opposing party is the IRS or another tax agency; and (b) other litigation support services (involving services involving a tax issue where a tax agency is not an actual or expected party to the dispute). Examples of litigation support include providing advice or assistance to legal counsel or providing expert testimony, in connection with the litigation.

63.2.2 All tax-related litigation services are approved by the partner in charge of the Department of Professional Practice—Tax.

63.2.3 Tax-related litigation services that do not involve actual or expected noncriminal litigation with an opposing party that is a tax agency also are approved by the area Forensic and Litigation Services approval partner and by the national professional

May 2002

practice partner—Forensic and Litigation Services, and are subject to the guidance provided by that practice. See PPL 00-121 for additional guidance at <http://taxkm.us.kworld.kpmg.com/homepages/dpp/index.htm>.

63.2.4 The Office of the General Counsel is consulted on tax-related litigation services involving:

- potential client conflicts (e.g., KPMG has clients on both sides of an issue);
- a prominent client or potential client;
- controversial subject matter; or
- a client or potential client that is a law or professional services firm providing services similar to those offered by KPMG.

63.3 Practice Before the Tax Court

63.3.1 Only designated Tax Controversy Services professionals may sign or file Tax Court petitions or appear before the Tax Court on behalf of a client and, usually, only if the amount in dispute is significant. Any exception to this policy is approved by the Office of General Counsel, in addition to the partner in charge of the Department of Professional Practice—Tax.

63.3.2 Firm personnel do not assist clients, or our clients' legal counsel, with the preparation of a Tax Court petition that is not signed by a designated tax controversy services professional.

63.3.3 Engagement letters for Tax Court services (i.e., for preparing, reviewing, signing or filing a petition, or for appearing before the Tax Court) are approved by the national partner in charge—Tax Controversy Services and the Department of Professional Practice—Tax and are signed by a designated tax controversy services professional (as well as the engagement partner, if different).

63.3.4 Although we may inform clients of the differences of litigating before a federal district court, the Court of Federal Claims and the Tax Court, it is the client's decision as to which forum to choose.

63.3.5 We do not represent any SEC registrant, any subsidiary or affiliate of an SEC registrant, or any officer or director of an SEC registrant (including any subsidiary or affiliate thereof) before the Tax Court, where the firm is, or is expected to become, the auditor of the SEC registrant.

63.4 Handling Potential Tax Fraud Cases

63.4.1 Engagements that involve a potential tax fraud investigation are not undertaken without consultation with the firm's Office of General Counsel and the partner in charge of the Department of Professional Practice—Tax. If we decide to accept such an engagement, legal counsel, rather than the taxpayer, will engage the firm and specify

the scope of the services to be performed. Under such circumstances, we engage in discussions with the taxpayer only in the presence and under the direction of the taxpayer's legal counsel.

- 63.4.2** In undertaking an engagement that involves a potential tax fraud investigation, the tax services engagement partner follows the client acceptance and approval policy outlined in Chapter 30 of this manual. If the engagement involves an assurance services client, the tax services engagement partner also consults with the area risk management partner and the assurance engagement partner.
- 63.4.3** If, during the course of an examination, an IRS agent discovers facts and circumstances indicating possible fraud, the agent must suspend the investigation at once and advise the group supervisor of these findings. If the group supervisor concurs that the findings indicate fraud, the matter is referred to the Criminal Investigation Division of the IRS through the appropriate channels. If, after reviewing the taxpayer's file, the latter division concludes that the matter warrants a fraud investigation, a special agent is assigned to conduct a joint investigation with the agent. Once assigned, the special agent is in charge of the investigation.
- 63.4.4** The examining IRS agent need not disclose directly to the taxpayer, or the taxpayer's representative, any suspicion of fraud. Therefore, firm personnel need to be alert in handling an examination to determine if the examination is other than routine in nature. This may be gleaned from:
- the nature of the specific queries;
 - the depth to which the agent probes in certain areas;
 - the particular items being examined; and
 - the type of records requested for the examination.

Since the agent must prepare an initial report of suspected fraud, the examination is likely to be more than routine in the areas under suspicion. If the agent, after incurring a reasonable period of time, suspends the examination, that fact in conjunction with other actions may signal the proposed course of action. Thus, it is important for firm personnel to be alert to a potential problem early enough in the examination to assist the client (directly, or indirectly through counsel).

- 63.4.5** If the agent's audit actions indicate suspicions of civil fraud, we ordinarily inform the client of such actions and the areas in which the agent expresses particular interest. If we anticipate potential criminal investigation, the firm promptly withdraws from the engagement, and the client is advised to obtain the immediate advice of legal counsel. We neither discuss the matter nor offer other advice directly to the client, except to the extent requested to do so by the client's attorney, and then only if subsequently engaged by the client's attorney to do so.

May 2002

- 63.4.6** The agent, after an absence, may reenter the examination accompanied by a special agent. In such case, the special agent, upon first contact with the taxpayer, is required to explain his or her identity and function and communicate the taxpayer's rights in this matter.
- 63.4.7** Our attitude toward the taxpayer in the foregoing circumstances is governed by many considerations. We do not act as judge or jury, or attempt to prejudge the case in any manner. The fact that a taxpayer is investigated by special agents, or even indicted, does not foreclose the possibility of our accepting an engagement from a reputable attorney to assist in the taxpayer's defense.
- 63.4.8** The tax services engagement partner or tax managing director promptly informs the Department of Professional Practice—Tax and the Office of General Counsel of any client involved in a fraud investigation. Also, if a request is made for our work papers in a situation relating to a potential fraud investigation, the Department of Professional Practice—Tax and the Office of General Counsel are consulted before the work papers are made available.

Chapter 64—Tax Legislative Activities

64.1 Policies

All federal tax legislative activities are approved, before commencing the activity, by the partner in charge of the Legislative and Regulatory Services practice, and all state tax legislative activities are approved, before commencing the activity, by the national professional practice partner—SALT and the appropriate SALT geographic area partner in charge.

There also are special approval requirements for nontax legislative activities performed by tax personnel.

64.2 Professional Practice Considerations

- 64.2.1 There are special approval and engagement responsibility requirements for federal, state and local tax legislative activities, because of:

Reputation risk: This is the risk that the firm's reputation, resources and contacts will be adversely affected by the nature of the engagement or the manner in which it is pursued.

Relationship risk: This is the risk that indiscriminate approaches to the Treasury, the Internal Revenue Service or members of Congress or staff or state legislatures and departments of revenue may adversely affect other firm initiatives or relationships with the participants in the legislative or administrative guidance process.

Conflicts risk: This is the risk that the engagement or the manner in which it is pursued will conflict with other legislative or administrative guidance initiatives or objectives of the firm or significant clients.

Regulatory risk: This is the risk that legislative or administrative guidance contacts may result in filing obligations that will be not be met if the contacts are not known.

Federal Tax Legislative Activities

64.3 Examples of Federal Tax Legislative Activities

- 64.3.1 Federal tax legislative activities include, but are not limited to: consultation with clients and participants in the tax legislative process with respect to legislative strategy; technical analysis of legislative issues and alternatives; drafting proposed legislation and accompanying technical explanation; review and analysis of legislative proposals and alternatives; preparation of advocacy documents; coordination (where appropriate) with other professionals (through coalitions, alliances and the like); communication (written or oral) with participants in the tax legislative process; and arranging and attending meetings with or on behalf of clients with Congressional staff, Executive Branch officials and members of Congress.

May 2002

64.4 Engagement Approval Requirements for Federal Tax Legislative Activities

- 64.4.1** For purposes of this section, federal tax legislative activities include proposed firm activities with respect to Department of the Treasury and Internal Revenue Service administrative guidance of general applicability (as compared to client specific guidance such as private letter rulings or technical advice memoranda), including, without limitation, communication with participants in the tax administrative guidance process, preparation of advocacy documents, arranging and attending meetings with or on behalf of clients with such participants, and the preparation and submission of written materials to such participants.
- 64.4.2** The firm offers federal tax legislative activities to clients individually or in groups (coalitions) on any matter in which the position sought by the client can be advanced on one or more technical, policy or equitable grounds and as to which, in the judgment of the partner in charge of the Legislative and Regulatory Services (LRS) practice after appropriate consultation with the partner in charge of the Department of Professional Practice—Tax and the partner in charge—Government Affairs, there is no legal or significant business conflict of interest.
- 64.4.3** Before commencing any federal tax legislative activity (including, for example, telephone inquiries to Congressional staff), the firm member seeking to engage in such activity contacts the partner in charge of the LRS practice. The partner in charge of the LRS practice makes the initial determination whether the contemplated engagement satisfies the threshold technical, policy or equitable criteria. If it does, the partner in charge of the LRS practice consults with the partner in charge—Government Affairs in reaching a decision whether to proceed. Upon the decision of the partner in charge of the LRS practice to proceed, the normal engagement screening process occurs, including the identification of any legal, as well as potential business conflicts of interest. In the event the latter are identified, the partner in charge of the LRS practice consults, as appropriate, with the partner in charge of the Department of Professional Practice—Tax in reaching a decision whether to undertake the engagement. In the case of audit clients, the audit engagement partner, who in turn coordinates with the Department of Professional Practice—Assurance, is consulted prior to accepting any federal tax legislative engagement.
- 64.4.4** Federal tax legislative activities, other than those involving administrative guidance, are carried out by, or under the direction of, the partner in charge of the LRS practice. Activities involving administrative guidance are carried out in consultation with the partner in charge of the LRS practice.

State and Local Tax Legislative Activities**64.5 Examples of State and Local Tax Legislative Activities**

- 64.5.1** The following are examples of state and local tax legislative activities: providing technical comments on proposed regulations or legislation; meeting with state executive or legislative branch officials with the purpose of influencing administrative action or legislation; meeting informally with state executive or legislative branch officials to determine the effect of an administrative release or legislation; or providing

testimony as state and local tax experts or economic development experts at a legislative or administrative hearing.

- 64.5.2** The determination of whether a person performing one or more of the above activities is engaged in lobbying will, in some jurisdictions, turn on the value of the fee that the person or his or her employer receives in conjunction with those activities. This minimum fee requirement is often nominal.

64.6 Engagement Approval Requirements for State Tax Legislative Activities

- 64.6.1** In jurisdictions where the firm is engaged in state and local tax legislative services, the firm and the professionals performing the legislative services may be subject to disclosure/registration requirements as well as restrictions, such as a prohibition on accepting a contingent fee in connection with any lobbying services. Such requirements also vary widely by jurisdiction. Accordingly, before engaging in any potential state tax legislative activity, the approval procedures provided below are followed.
- 64.6.2** Before conducting any state or local tax legislative activities or registering as a lobbyist in any jurisdiction, the firm member seeking to perform the services or to register obtains approval from the national professional practice partner—SALT, as well as the appropriate SALT geographic area partner in charge. As in the case of federal tax legislative activities, the contemplated activity or engagement is evaluated to determine if there are no legal or potential business conflicts of interest. In determining whether to approve the activity, the professional practice partner—SALT consults with the partner in charge—Government Affairs and the partner in charge of the Department of Professional Practice—Tax. In addition, in the case of audit clients, the audit engagement partner, who in turn coordinates with the Department of Professional Practice—Assurance, is consulted prior to accepting any state and local tax legislative engagement. Refer to Chapter 31 of this manual regarding the engagement letter approval process for engagement letters involving state lobbying activities.
- 64.7 Other Legislative Activities by Tax Personnel**
- 64.7.1** Any federal legislative activity not directly involving tax matters proposed to be conducted by tax personnel (e.g., economic consulting testimony in support of nontax legislation) is approved, prior to making a commitment to engage in the activity, by the partner in charge—Government Affairs, who consults as appropriate with the partner in charge of the Department of Professional Practice—Tax. Any state and local legislative activity not directly involving tax matters proposed to be conducted by tax personnel (e.g., testimony in support of nontax incentives sought by a client from a state or local government) is subject to the approval procedures applicable to state and local tax legislative activities. In addition, any federal, state or local legislative activity not directly involving tax matters proposed to be provided on behalf of an audit client is approved, prior to making a commitment to engage in the activity, by the Independence Group in the Department of Professional Practice—Assurance.

May 2002

64.8 Comment Letters Approval Requirements

- 64.8.1** The approval requirements for technical comment letters to government agencies are set forth in Chapter 60 of this manual.

May 2002

Appendix A—Federal Tax Protest—Transmittal Form

Date

Page 1 of

To

Organization KPMG WNT

Fax

From

Department

Tel

Fax

Subject

TIME SENSITIVE—Preissuance Review of Federal Protest

Name of Client: _____

Project Number: _____

Date Protest Due at IRS: _____

Date WNT Response Is Required By: _____

If the protest's technical issues were discussed with a Washington National Tax professional(s) or other national resource, please indicate name(s):

Other Comments:

The information contained in this facsimile message is privileged and confidential information intended solely for the use of the addressee listed above. If you are neither the intended recipient nor the employee or agent responsible for

delivering this message to the intended recipient, you are hereby notified that any disclosure, copying, distribution or the taking of any action in reliance on the contents of the telefaxed information is strictly prohibited. If you have

received this telefax in error, please immediately notify us by telephone (call collect to the number listed above) to arrange for the return of the original document to us.

Appendix B—Citations Guide

For detailed guidance on how to cite authorities or other documents, please see the latest edition of *The Bluebook: A Uniform System of Citation*, published by Harvard Law Review Association. Alternatively, please see the abbreviated guidance below.

A. Statutes	<u>Within text</u>	<u>Outside text</u>
• Internal Revenue Code of 1986	Section 212 of the Internal Revenue Code of 1986; Section 212 of the Code; Section 212	I.R.C. Sec. 212
• Internal Revenue Code of 1954	Section 162 of the Internal Revenue Code of 1954; Section 162 of the 1954 Code; Section 162 (1954)	I.R.C. Sec. 162 (1954)
• Internal Revenue Code of 1939	Section 22 of the Internal Revenue Code of 1939; Section 22 (1939)	I.R.C. Sec. 22 (1939)
• Revenue Acts	Revenue Act of 1924, Section 200	Sec. 200, Rev. Act (1924)
B. Treasury material		
• Treasury Regulations:		
1) Current income tax	Regulation Section 1.6411-2(a)	Reg. Sec. 1.6411-2(a)
2) Current estate tax	Regulation Section 20.2031	Reg. Sec. 20.2031
3) Current gift tax	Regulation Section 25.2511-3	Reg. Sec. 25.2511-3
4) Proposed	Proposed Regulation Section 1.482-1(d), 31 Federal Register 10394* (August __, 1966) **; Proposed Regulation Section 1.482-1(d)	Prop. Reg. Sec. 1.482-1(d), 31 Fed. Reg. 10394* (Aug. __, 1966)**; Prop. Reg. Sec. 1.482-1(d)
5) Procedure	Regulation Section 301.6656-1	Reg. Sec. 301.6656-1

* Cite to page on which Notice of Proposed Rulemaking begins.

** Date of publication, *not* date of filing.

May 2002

	<u>Within text</u>	<u>Outside text</u>
• Other Treasury material:		
Cite to Cumulative Bulletin (C.B.) or Internal Revenue Bulletin (I.R.B.)		
1) General Counsel's Memorandum: (formerly Chief Counsel's Memorandum)	General Counsel's Memorandum 29, 1 C.B. 230 (1919) (use exact date if not in C.B.)	G.C.M. 29, 1 C.B. 230 (1919) (use exact date if not in C.B.)
2) Estate and Gift Tax Ruling	Estate and Gift Tax Ruling	E.T.
3) Income Tax Ruling	Income Tax Ruling 2624, XI-1 C.B. 122 (1932)	I.T. 2624, XI-1 C.B. 122 (1932)
4) Revenue Ruling (pre-1954)	Revenue Ruling 131, 1953-2 C.B. 112; Revenue Ruling 131	Rev. Rul. 131, 1953-2 C.B. 112; Rev. Rul. 131
Revenue Ruling (post-1953)	Revenue Ruling 54-292, 1954-1 C.B. 896; Revenue Ruling 54-292	Rev. Rul. 54-292, 1954-1 C.B. 896; Rev. Rul. 54-292
5) Revenue Procedure	Revenue Procedure 65-13, 1965-1 C.B. 87; Revenue Procedure 65-13	Rev. Proc. 65-13, 1965-1 C.B. 87; Rev. Proc. 65-13
6) Solicitor's Memorandum	Solicitor's Memorandum	S.M.
7) Private Letter Ruling	Private Letter Ruling No. 8568943	PLR 8568943
C. Legislative material		
• Public laws	Public Law No. 89-25 (optional: 89th Congress, 2d Session, sec. 50 (1964))	Pub. L. No. 89-25, Sec. 50, 77 Stat. 25 (1964)
• Private laws	Private Law No. 89-148, 79 Statute 1390 (1965)	Priv. L. No. 89-148, 79 Stat. 1390 (1965)
• Senate bills	S. 383, 83d Congress, 2d Session, Sec. 84 (1954)	S. 383, 83d Cong. 2d Sess. Sec. 84 (1954)

	<u>Within text</u>	<u>Outside text</u>
• House bills	H.R. 136, 79th Congress, 1st Session (1945)	H.R. 136, 79th Cong. 1st Sess. (1945)
• Senate reports	S. Rep. No. 355, 84th Congress, 2d Session 7 (1956)	S. Rep. No. 355, 84th Cong. 2d Sess. 7 (1956)
• House reports	H.R. Rep. No. 353, 82nd Congress, 1st Session 14 (1951)	H.R. Rep. No. 353, 82d Cong. 1st Sess. 14 (1951)
• Conference reports	H.R. Rep. No. 95-263 (Conference Report), 95th Congress, 1st Session 12 (1977)	H.R. Rep. No. 95-263 (Conf. Rep.), 95th Cong. 1st Sess. 12 (1977)
• Congressional hearings	Committee, <i>Title</i> , Cong. Sess. page (date) (for example, U.S. Senate Committee on Finance, <i>Tax Reduction Proposals</i> , 97th Cong. 1st Sess. 29 (May 20, 1981))	Hearing on (number of bill) before (name of committee), 79th Cong. 1st Sess. 19 (1948)
• Congressional record:		
1) Daily edition	103 <i>Congressional Record</i> S13,718 (August 16, 1957)	103 <i>Cong. Rec.</i> S13,718 (Aug. 16, 1957)
2) Bound edition	99 <i>Congressional Record</i> 2988 (1954) (Remarks of Senator Eastland)	99 <i>Cong. Rec.</i> 2988 (1954) (Remarks of Senator Eastland)

D. Cases

- General: In general, the name of a case is cited as it appears at the beginning of the opinion in the official reporter. If the Commissioner of Internal Revenue is a party, "Commissioner" is *never* abbreviated. If the United States is a party, "United States" is *never* abbreviated.

Example: In *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965), the Ninth Circuit affirmed this view. But see *Commissioner v. Otis*, 372 U.S. 789 (1956); *Pike v. Commissioner*, 290 F.2d 656 (2d Cir. 1954); *Lukins v. United States*, 312 F.2d 803 (Ct. Cl. 1963).

- Federal courts (other than Tax Court and Board of Tax Appeals): For a list of courts and their correct abbreviation, see *A Uniform System of Citation*, The Harvard Law Review Association.

May 2002

Supreme Court cases are cited to the official reporter (U.S.), if available. If the official reporter has not yet appeared, cite to Supreme Court Reporter (S. Ct.). Federal Courts of Appeal, District Courts and Court of Federal Claims (previously U.S. Court of Claims and U.S. Claims Court) cases are cited to the Federal Reporter (F., F.2d) and Federal Supplement (F. Supp.). Use either the official reporter or the CCH U.S.T.C. or RIA A.F.T.R. cite. If none is available, use the docket number and date of the decision.

Examples: *Supreme Court—Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 55-1 U.S.T.C. para. 9308 (1955).

Courts of Appeal—Commissioner v. Kahn's Estate, 174 F.2d 357, 359 (3d. Cir. 1949); *Gerstacker v. Commissioner*, 69-2 U.S.T.C. para. 9580 (6th Cir. 1969) or 24 A.F.T.R. 2d para. 69-5109 (6th Cir. 1969).

District Courts (give only the district, not the division, in which the case was decided)—*Mobile Drug Co. v. United States*, 39 F.2d 940, 2 U.S.T.C. para. 492 (D.C. Ala. 1930); *United States v. Pine*, 69-2 U.S.T.C. para. 9603 (E.D. Wis. 1969) or 24 A.F.T.R. 2d para. 69-5098 (E.D. Wis. 1969).

Court of Federal Claims (previously the *Court of Claims and Claims Court*)—Cite to F., F.2d, or F. Supp.—*Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967).

If not therein, cite to the official reporter or the official reporter advance sheets (Federal Claims Reporter (Fed. Cl.) for 1992-present, United States Claims Court Reporter (Cl. Ct.) for 1982-1992, and United States Court of Claims Reports (Ct. Cl.) for 1956-1982)—*Eli Lilly & Co. v. United States*, 178 Ct. Cl. 666 (1967) or 178 Ct. Cl. No. 293-61 (Feb. 17, 1967).

Also, cite to the preferred unofficial reporter (U.S.T.C. or A.F.T.R.)—*Eli Lilly & Co. v. United States*, 67-1 U.S.T.C. para. 9248 or 19 A.F.T.R. 2d para. 67-406.

If not therein, the unpublished Trial Commissioner's Report may be found in the "current" volume of the respective tax service—*Eli Lilly & Co. v. United States*, (1967) 7 Stand. Fed. Tax Rep. (CCH) para. 8154 or (1967) 6 Fed. Taxes (P-H) para. 58-034. The citations designate the year, volume of service, name of service (as of date of publication), publisher (as of date of publication) and paragraph number.

- Tax Court and Board of Tax Appeals:

- 1) Regular decisions—Tax Court (T.C.) and Board of Tax Appeals (B.T.A.) cases are cited to the official reporter. If the taxpayer is an individual, the first name, middle initial and last name are cited. If the taxpayer's spouse also is a party (by virtue of filing a joint return), cite only the first party's full name. If the case has not yet been officially reported, cite the number of the case followed by the actual date of the decision. Do not use *et al.* or other abbreviations indicating multiple parties. Rather, cite only the first-listed party on each side. Do not omit, however, the first-listed realtor or any portion of a partnership name. Omit all procedural phrases except the first. If adversary parties are named, omit all procedural phrases.

Examples: The Lake Erie and Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), *nonacq.* 1965-1 C.B. 5.

Mary Schwab v. Commissioner, 52 T.C. No. 84 (Aug. 14, 1969).

J. Darsie Lloyd v. Commissioner, 33 B.T.A. 903 (1936), *acq.* 1950-2 C.B. 3.

John E. Leslie v. Commissioner, 50 T.C. 11 (1968), *rev'd*, 24 A.F.T.R. 2d para. 69-5064 (2d Cir. 1969). If you are citing the Second Circuit's opinion in support of your point, the form of citation is *Leslie v. Commissioner*, 24 A.F.T.R. 2d para. 69-5064 (2d Cir. 1969), *rev'g* 50 T.C. 11 (1968). (Note: A.F.T.R. 2d was cited because the case did not yet have an official reporter citation or did not appear in the official reporter.)

- 2) Memorandum decisions—Since these decisions are not officially reported, it is necessary to cite to either *CCH* or *RIA*. *CCH* citations are used for Tax Court Memorandum decisions since these citations indicate the page number at which the decision can be found. Since *RIA* merely supplies you with the paragraph number, an *RIA* citation tends to be awkward if you are using a citation to support a quotation.

Examples: *CCH—Federal Distributing Co. v. Commissioner*, 22 T.C.M. 935 (1963).

P-H (now RIA)—Federal Distributing Co. v. Commissioner, T.C. Memo. 1963-193.

- 3) Acquiescences and nonacquiescences—Acquiescences need not be given unless the author regards them as significant. Nonacquiescences are *always* given. If given, a citation to the place of acquiescence or nonacquiescence follows immediately after the Tax Court or Board of Tax Appeals decision.

Examples: *The Federal Machine and Welder Co. v. Commissioner*, 11 T.C. 952 (1948), *acq.*, 1949-1 C.B. 2, *aff'd*, 184 F.2d 843 (6th Cir. 1950).

The Lake Erie and Pittsburgh Railway Co. v. Commissioner, 5 T.C. 558 (1945), *nonacq.*, 1965-1 C.B. 5.

Good Faith Estimate of Top Revenue-Generating Strategies¹

Year 2000	Year 2001	Year 2002
401(k) Enhanced Deduction Acceleration Strategy (401kACCEL)	Acquisition Cost Recovery Analysis (ACRA)	Acquisition Cost Recovery Analysis (ACRA)
Acquisition Cost Recovery Analysis (ACRA)	Credit Card Fee Deferral Strategy (CARDS)	California REIT
Bond Linked Issue Premium Structure (BLIPS)	Contested Liability Acceleration Strategy (CLAS)	Cost Segregation Services (Cost Seg)
Canadian Migration Program from the U.S. (CAMPUS)	Export Tax Management Services (ETM)	Export Tax Management Services (ETM)
Contested Liability Acceleration Strategy (CLAS)	Intangible Holding Company Structure (IHCO)	Operations Consolidation Strategy (OPCO)
Intangible Holding Company Structure (IHCO)	Optional Tax-Deductible Hybrid Equity while Limiting Local Obligation (OTHELLO)	Optional Tax-Deductible Hybrid Equity while Limiting Local Obligation (OTHELLO)
Offshore Portfolio Investment Strategy (OPIS)	Regular Interest/Preference Shares Strategy (RIPSS)	Research Credit Review Services
SAT Procurement Suite	SAT Procurement Suite	SAT Procurement Suite
S-Corporation Charitable Contribution Strategy (SC2)	S-Corporation Charitable Contribution Strategy (SC2)	SAT Unclaimed Property
Tax-Efficient Minority Preferred Equity Sale Transaction (TEMPEST)	Tax-Efficient Minority Preferred Equity Sale Transaction (TEMPEST)	Tax-Efficient Minority Preferred Equity Sale Transaction (TEMPEST)

¹ As described in greater detail in the covering letter, because each tax strategy is tailored to a client's particular circumstances, the firm does not maintain any systematic, reliable method of recording revenues by tax product on a national basis, and therefore is unable to provide any definitive list or quantification of revenues for a 'top ten tax products', as requested by the Subcommittee. In an effort to assist the Subcommittee, the firm has undertaken a good faith, reasonable effort to estimate the tax strategies that were likely among those generating the most revenues in the years requested. Those strategies are the ones contained on this list. However, and because accurate and reliable data do not exist in the form requested by the Subcommittee, this list should not be characterized as an official list of the firm's 'top ten generic tax products' for each year.

Proprietary Material
Confidentiality Requested

KPMG 0001801

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 57

3245

kpmg Peat Marwick LLP

Financial Services

To Jeffrey N. Stein

Date May 26, 1998

From Gregg W. Ritchie
Los Angeles/Woodland Hills

Steno gwr
Ref c:\user\gwr\hewl\wp1\coll\cgs1
6111 #.doc c:\windows\temp\

cc Distribution List

OPIS Tax Shelter Registration

Attached is a memorandum from Jeff Zysik (Tax Innovation Center) concerning the potential financial consequences associated with failing to register a tax shelter under IRC section 6111. For purposes of this discussion, I will assume that we will conclude that the OPIS product meets the definition of a tax shelter under IRC section 6111(c).

Based on this assumption, the following are my conclusions and recommendations as to why KPMG should make the business/strategic decision not to register the OPIS product as a tax shelter. My conclusions and resulting recommendation are based upon the immediate negative impact on the Firm's strategic initiative to develop a sustainable tax products practice and the long-term implications of establishing such a precedent in registering such a product.

First, the financial exposure to the Firm is minimal. Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees. Furthermore, as the size of the deal increases, our exposure to the penalties decreases as a percentage of our fees. For example, our average deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000.

This further assumes that KPMG would bear 100 percent of the penalty. In fact, as explained in the attached memo, the penalty is *joint and several* with respect to anyone involved in the product who was required to register. Given that, at a minimum, Presidio would also be required to register, our share of the penalties could be viewed as being only one-half of the amounts noted above. If other OPIS participants (e.g., Deutsche Bank, Brown & Wood, etc.) were also found to be promoters subject to the registration requirements, KPMG's exposure would be further minimized. Finally, any ultimate exposure to the penalties are abatable if it can be shown that we had reasonable cause.

Second, the rules under section 6111(c) have not changed significantly since they were imposed in 1984. While there was an addition to section 6111 in the 1997 Tax Act, it only applies to products marketed to corporate investors under limited circumstances. To my knowledge, the Firm has never registered a product under section 6111 and it is my opinion that we should not begin with OPIS.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 65

KPMG 0012031

KPMG Peat Marwick LLP

Page 2
 Distribution List
 February 6, 2002 May 26, 1998

Third, the tax community at large continues to avoid registration of all products.

Based on my knowledge, the representations made by Presidio and Quadra, and Larry DeLap's discussions with his counterparts at other Big 6 firms, *there are no tax products marketed to individuals by our competitors which are registered.* This includes income conversion strategies, loss generation techniques, and other related strategies.

Should KPMG decide to begin to register its tax products, I believe that it will position us with a severe competitive disadvantage in light of industry norms to such degree that we will not be able to compete in the tax advantaged products market.

Fourth, there has been (and, apparently, continues to be) a lack of enthusiasm on the part of the Service to enforce section 6111.

In speaking with KPMG individuals who were at the Service (e.g., Richard Smith), the Service has apparently *purposefully* ignored enforcement efforts related to section 6111. In informal discussions with individuals currently at the Service, WNT has confirmed that there are not many registration applications submitted and they do not have the resources to dedicate to this area.

Finally, the guidance from Congress, the Treasury, and the Service is minimal, unclear, and extremely difficult to interpret when attempting to apply it to "tax planning" products. The Code section, regulations and related material were clearly written with a view toward the sale of "traditional" tax shelters. That is, the rules anticipate that there will be the sale of a partnership interest by a promoter which purports to allow an investor to claim deductions significantly in excess of their investment. While the rules are written broadly enough to arguably include OPIS and other purely tax planning products, they are not easily applied to the marketing of an idea or strategy to a client which carries with it tax advantage.

Although OPIS includes the purchase of securities by the investor, the tax results are driven simply by an interpretation of the application of Code section 302 and the regulations thereunder. When coupled with the Service's apparent lack of enforcement effort, the lack of specific guidance is a further indication that the risk of noncompliance with the rules could be excused.

Based on the above arguments, it is my recommendation that KPMG does *not* register the OPIS product as a tax shelter. Any financial exposure that may be

KPMG Peat Marwick LLP

Page 3
Distribution List
February 6, 2002~~May 26, 1998~~

applicable can easily be dealt with by setting up a reserve against fees collected. Given the relatively nominal amount of such potential penalties, the Firm's financial results should not be affected by this decision.

In ~~summary~~summary, I believe that the rewards of a successful marketing of the OPIS product (and the competitive disadvantages which may result from registration) far exceed the financial exposure to penalties that may arise. Once you have had an opportunity to review this information, I request that we have a conference with the persons on the distribution list (and any other relevant parties) to come to a conclusion with respect to my recommendation. As you know, we must immediately deal with this issue in order to proceed with the OPIS product.

Distribution List:

Mark Springer

Doug Ammerman
Walter Duer

new

From: Larry DeLap at KPMG_Silicon_Valley2
 Sent: Tuesday, September 01, 1998 8:44 AM
 To: Albaugh, William E; Cohen, David; Elker, Stephen P; Fuller, Diane D; McKee, James F; Messing, Steven G; Ritchie, Lewis R; Auer, Charles J; Bendheim, Rudge E; Connolly, William J; Cveach, Gary D; Guempel, Scott R; George S. Hoenig at KPMG_Stamford; Jend, George P; Mahoney, Michael P; Nelson, Dennis G; Norton, Sandra H; O'Brien, Timothy J; Page, Ralph A; Scott, Robert A; Vogt, Gary A; Walker, James D; Welner, Howard J; Willock, David L
 Cc: Elscheld, Jeffrey A
 Subject: OPIS

opis-100.doc opis-101.doc opis-102.doc opis-103.doc opis-104.doc

One of the

products currently being marketed by the CATs group of PFP is the Offshore Portfolio Investment Strategy ("OPIS").

I am attaching, for your information, some material on OPIS, including a draft opinion letter and a standard engagement letter.

OPIS should be marketed only to individuals. It should not be marketed to corporations.

OPIS has a high degree of investment and tax risk. Accordingly, it is essential we get a signed engagement letter from the client before he invests any funds in the strategy. The standard engagement letter attached is to be used. On a case by case basis, it is okay to increase the maximum liability from the \$50,000 indicated in the standard letter, but not to an amount in excess of our fee for the engagement. Any other change in the standard letter should be cleared with me. (If, based on experience, we make some revisions to the standard letter, I will communicate that to you.)

The product owner of OPIS is Jeff Elscheld, Atlanta. If you have any marketing related questions on OPIS, please call Jeff. Any professional practice questions or concerns on the product should be directed to me.

Larry

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 68

KPMG 0035702



KPMG DRAFT: 7/1/98

Investor
[Address]

You have requested our opinion regarding the U.S. federal income tax consequences of certain investment portfolio transactions that have been concluded by Investor, an [Individual/LLC/Partnership/Trust]. As more fully described below, Investor participated in a series of securities transactions involving XYZ Bank,¹ ("Foreign Bank") common stock.

Presidio Advisors, LLC ("Investment Advisor"), an independent investment advisor registered under the 1940 Investors Act, acted as investment advisor to Investor. In this capacity, Investment Advisor provided investment advice to Investor with respect to a Foreign Bank investment strategy that Investment Advisor designed. Prior to commencement of trading in Foreign Bank securities, Investment Advisor generated the attached technical analysis which sets forth the potential financial returns from participation in the Foreign Bank investment strategy. Based upon Investor's independent assessment of the analysis, Investor believed that by engaging in the integrated investment strategy devised by Investment Advisor it had a reasonable expectation of earning a reasonable pre-tax profit from the securities transactions described, in excess of all associated fees and costs and without regard to any tax benefits that may occur.

The basic design of the investment strategy was premised upon the expectation that a highly leveraged position in Foreign Bank securities would provide Investor with the opportunity for capital appreciation. In order to maximize the utilization of foreign capital market credit facilities, Investor entered into a swap transaction. The other participant in the swap was a foreign (non-U.S.) taxpayer, an individual/LLC ("Limited Partner"), that had a 90% limited partnership interest in a Cayman Islands limited partnership ("Foreign LP") which invested in Foreign Bank securities. Investor further increased its investment position in Foreign Bank by making a direct purchase of Foreign Bank stock and options.

Our opinion and supporting analysis is based upon the following description of the facts, assumptions and representations associated with the investment portfolio transactions undertaken by Investor. In rendering our opinion, we have reviewed the

¹ XYZ is _____ and its securities are publicly-traded on the _____ Stock Exchange.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 2

applicable provisions of the Internal Revenue Code of 1986 ("Code"), as amended, and the final, temporary, and proposed Treasury Regulations ("Treas. Reg.") promulgated thereunder; relevant decisions of the U.S. federal courts; published Revenue Rulings ("Rev. Rul.") and Revenue Procedures ("Rev. Proc.") of the Internal Revenue Service ("Service") and other materials as we have considered relevant².

Our opinion is limited to the conclusions expressed below in that portion of our opinion labeled "*Summary of Opinion*" and "*Conclusion*".

² Code Section 6110(j)(3) provides that a written determination, e.g., a private ruling, determination letter, or technical advice memorandum, may not be used or cited as precedent. However, in *Xerox Corp. v. U.S.*, 656 F.2d 659 (D.C. Cir. 1981), the court noted that although private letter rulings have no precedential value, "they are helpful, in general, in ascertaining the scope of the ... doctrine adopted by the Service and in showing that the doctrine has been regularly considered and applied by the Service."

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 3

I. Description of Investment Transactions

A. Initial Investment Structure

As noted, the investment strategy undertaken by Investor was designed by Investment Advisor. Investor used a combination of derivative securities, call/put options and long positions in Foreign Bank stock to optimize its overall portfolio position. A prime underlying tenet of the investment strategy was to maximize the degree of available leverage to finance the investment in Foreign Bank securities. Through participation in a swap transaction, Investor was able to benefit from Foreign LP's ability to secure 100 percent financing for its investment in Foreign Bank securities. In addition, Investment Advisor structured a complementary financing package with Foreign Bank with respect to Investor's direct purchases of Foreign Bank securities.

Investor's participation in the swap transaction was an integral component of the investment strategy. The swap effectively allowed Investor to take a position in Foreign Bank stock on margin terms that were unavailable in U.S. capital markets and it also allowed Investor to avoid the negative impact of the related liability on its balance sheet. Investment Advisor has represented to us that Investor could not have made a direct investment in Foreign Bank securities with similar margin terms nor could Investor, as an individual, have structured the derivative security investment that was incorporated in the portfolio of Foreign LP.

On [date], Investor purchased [number] shares of Foreign Bank stock on the Frankfurt Stock Exchange at a price of [DM price] per share (approximately \$_____) and entered into option contracts to purchase an additional [number] shares of Foreign Bank stock at a strike price of [DM price] per share and a [date] expiration date.

On [date], Investor entered into the swap transaction with Limited Partner. Under the terms of the swap, Investor made two payments totaling [\$] to Limited Partner and Limited Partner agreed to pay to Investor at termination of the contract an amount which equates to 90% of Limited Partner's distributive share of income and gain from its Foreign LP interest. If Foreign LP had liquidated before the termination of the contract or the partnership assets had not been sold, the assets were to be marked to market to

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 4

determine the amount of Limited Partner's payment to Investor. The swap was an unsecured obligation of Limited Partner and imposed no limitation upon Limited Partner's ability to sell or otherwise dispose of its interest in Foreign LP.

Foreign LP is a limited partnership organized under the laws of the Cayman Islands. Foreign LP is 90% owned by Limited Partner, a foreign taxpayer unrelated to Investor, and 10% owned by a Cayman Islands exempted company that acts as the general partner in Foreign LP ("General Partner"). General Partner is wholly-owned by Limited Partner. Limited Partner contributed [\$] in return for a 90% interest in Foreign LP and General Partner contributed [\$] in return for its 10% interest. In addition, Limited Partner and General Partner loaned Foreign LP [\$--approximately 50 percent of Foreign LP's funding is through debt], respectively. Limited Partner and General Partner generally share profit and loss based upon a 90/10 ratio. However, gains and losses from the disposition of Foreign Bank stock not subject to a call option, as described below, are shared in a ratio of 10/90. Limited Partner has represented to Investment Advisor that it has substantial assets in addition to its investment in Foreign LP and General Partner.

On [date], Investor purchased a call option from Limited Partner to acquire 50% of Limited Partner's interest in General Partner. The cost of the option was [\$--2.5% of the notional investment amount] and its exercise price was [\$--50% of the notional investment amount]. Under the terms of the option, Investor could have either exercised the option to purchase 50% of General Partner or, alternatively, the option could have been cash settled based upon the option's "put value"¹. The option's expiration date was [date] and the option could not be exercised within 60 days of its issuance.

Foreign LP purchased [number] shares of Foreign Bank at a price of [DM price] per share (approximately \$ _____) on [date]. We have been advised by Investment Advisor that because Foreign LP's purchase of Foreign Bank shares was not subject to U.S. margin requirements under Federal Reserve Regulation T, Foreign LP was able to finance 100 percent of its intended share purchase by borrowing the purchase price from

¹ The "put value" was equal to the net asset value of General Partner multiplied by the percentage interest in General Partner covered by the option (e.g., if the option entitled the holder to an 50% interest in General Partner, the put value was equal to 50% of General Partner's net asset value). Net asset value was defined as the fair market value of net assets less liabilities less existing shareholder equity.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 5

Foreign Bank on a full recourse basis. Neither General Partner nor Limited Partner owned any other Foreign Bank shares during the time that Foreign LP held these shares.

In order to protect its leveraged investment position from a significant drop in the price of Foreign Bank, Investment Advisor advised Foreign LP to enter into the following option transactions. Foreign LP purchased European-style⁴ put options from Foreign Bank with a strike price of [DM price] per share and a [date] expiration date on 100 percent of its Foreign Bank shares. This price was significantly out of the money as that term is defined by Treas. Reg. Section 1.246-5(c)(2). The put options provided for optional cash settlement.

Additionally, on [date], Foreign LP sold European-style barrier call options to Foreign Bank with a [DM price] strike price and a [date] expiration date on 90% of its Foreign Bank share position. The call options incorporated a knock-out feature whereby the original options expire if the Foreign Bank shares traded below [DM price, respectively] prior to the option's expiration.⁵ In the event that the price of Foreign Bank stock trades below the knock-out strike price, the option is replaced with a second option with a knock-in strike price of [DM price]. The chief advantage of using barrier options is that they are considerably cheaper than conventional options because the probability that they will be exercised is lower. The call options provided for optional cash settlement. Embedded within the call option contract was a derivative option described as the "Asian" option (see Exhibit A for Investment Advisor's description). With the Asian option, Foreign LP could earn a return based upon the average closing price of Foreign Bank stock relative to a pre-established benchmark price over the period that the option was outstanding. *(This paragraph must be modified to describe the structure of the specific embedded derivative used in that the instrument is subject to change to accommodate differing investment strategies)*

B. Investor Ownership Structure

[Description of Foreign LP/Partnership/Trust ownership structure]

⁴ A European-style option can only be exercised on one particular day, whereas an American-style option can be exercised on or at any time before the exercise date.

⁵ In light of the knock-out feature, the original option is considered expired when the second strike, the barrier, is crossed.

Investor
June 1, 1998
Page 6

C. Subsequent Events

On [date], Foreign Bank exercised its call options and purchased [number] Foreign Bank shares from Foreign LP for the [DM price] per share option strike price. On [date], Foreign LP also sold its remaining position, [number] shares in Foreign Bank stock to Foreign Bank at [DM price] per share. In order to satisfy its delivery requirements under the option contracts, Foreign LP elected to deliver the Foreign Bank shares held in its portfolio rather than purchasing incremental Foreign Bank shares on the open market. We have been advised by Investment Advisor that there were no agreements between Foreign LP and Foreign Bank that could have compelled Foreign Bank to redeem the Foreign Bank shares held by Foreign LP.

In accordance with Investment Advisor's integrated strategic investment plan, simultaneous with the [date] redemption, Investor directly purchased [number] over-the-counter call options from Foreign Bank in order to sustain the economics of its derivative position in Foreign Bank securities. Accordingly, the number of the options purchased was equal to the number of shares Foreign Bank redeemed. On [date], the Foreign Bank call options were sold back to Foreign Bank and yielded a profit/loss of [\$_____] *[or alternatively expired worthless without having been exercised.]*

On [date], Investor elected to sell back to Limited Partner for its value of [\$ amount] its option to acquire 50% of Limited Partner's interest in General Partner *[or alternatively Investor has opted to allow the option to expire worthless]*. As noted above, the cost of this option on [date] was [\$ amount]. As of the date of this opinion, Investor continues to hold its portfolio investment in Foreign Bank shares *[or alternatively the shares were sold at (\$ price) and yielded a profit or loss of (\$ amount)]*. Investor elected to liquidate its position in Foreign Banks shares in order to capture its profits to date or alternatively in order to mitigate its loss position to date.]

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 7

II. Representations and Assumptions

A. Representations Made to KPMG by Investor

In connection with the transactions described above, Investor has represented to KPMG Peat Marwick LLP ("KPMG") the following:

- There was no legally binding agreement, written or otherwise, that compelled any of the parties to complete these transactions in the way described herein.
- Investor independently reviewed the economics underlying the investment strategy and believed it had a reasonable opportunity to earn a reasonable pre-tax profit from each of the transactions described herein, in excess of all associated fees and costs and not including any tax benefits that may occur.
- Prior to entering the current investment strategy, Investor owned no other shares of Foreign Bank stock.
- Based upon its review of publicly available financial information and to the best of Investor's knowledge, Foreign Bank is highly profitable on a worldwide basis.
- Foreign LP, Investor, Limited Partner, General Partner, Investment Advisor and Foreign Bank each acted independently and at arm's length with respect to the above transactions.
- There were no written agency agreements (apart from a standard investment advisory agreement) consummated with respect to the above transactions and none of the parties involved held itself out to a third party as an agent of any of the others with respect to these transactions.
- Investor did not have the ability to control, directly or indirectly, the actions of Foreign LP.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 8

- Investor has provided us with all facts and circumstances that it knows, or has reason to know, are pertinent to this opinion letter and believes that all assumptions or representations on which this opinion relies are reasonable.

B. Representations Made to KPMG by General and Limited Partner

In connection with the transactions described above, General Partner has represented to KPMG the following:

- Neither General Partner nor Limited Partner owned any Foreign Bank shares during the time that Foreign LP held its Foreign Bank shares.
- Foreign LP is not and has never been engaged in a U.S. trade or business.
- During all periods relevant hereto, Limited Partner is not tax resident in the United States and neither Limited Partner nor General Partner has been engaged in a U.S. trade or business.
- Foreign LP has complied with all registration requirements and other formalities as required under the laws of the Cayman Islands.
- The affirmative elections under Treas. Reg. Section 301.7701-3(c) to treat Foreign LP and General Partner as corporations for U.S. federal income tax purposes have been made.
- Limited Partner has substantial assets in addition to its investment in Foreign LP and General Partner.

C. Representations Made to KPMG by Investment Advisor

In connection with the transactions described above, Investment Advisor has represented to KPMG the following:

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 9

- There was no legally binding agreement, written or otherwise, that compelled any of the parties to complete these transactions in the way described herein.
- Investor could not have made a direct investment in Foreign Bank securities with similar margin terms nor could investor, as an individual, structured the derivative security investment that was incorporated in the portfolio of Foreign LP.
- Prior to Foreign LP's purchase of its Foreign Bank shares, that it owned no shares, directly or indirectly, of Foreign Bank.
- Based upon its review of publicly available financial information and to the best of its knowledge, Foreign Bank is highly profitable on a worldwide basis.

D. Factual Assumptions Made by KPMG for Purposes of Our Opinion

In connection with the above transactions, KPMG has assumed the following:

- For purposes of characterizing the distribution received by Foreign LP in connection with the complete redemption of its stock ownership in Foreign Bank, Foreign Bank had sufficient earnings and profits within the meaning of Code Section 316 to cause the distribution to be treated as a dividend for U.S. federal income tax purposes.*

III. Summary of Opinion

Based on and subject to the facts, documentation, representations and assumptions described above and the discussion and analysis of the relevant statutory provisions and judicial doctrines below, we are of the opinion that under current U.S. federal income tax law there is a greater than 50 percent likelihood (i.e., it is "more likely

* Foreign Bank's retained earnings as reflected in its annual report dated (date) were (amount).

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 10

than not") that the following positions will be upheld if challenged by the Internal Revenue Service ("Service"):

- Foreign LP and General Partner will be classified as corporations for U.S. federal income tax purposes with respect to the transactions analyzed herein;
- The amount paid to Foreign LP by Foreign Bank in redemption of the Foreign Bank shares owned by Foreign LP will be treated as a dividend under Code Sections 301 and 316;
- Foreign LP's tax basis in the redeemed Foreign Bank shares will be attributed and allocated to Investor's separately purchased Foreign Bank shares pursuant to Treas. Reg. Section 1.302-2(c) (and potentially to Investor's Foreign Bank options under Treas. Reg. Section 1.61-6);
- Investor will not be subject to U.S. taxation with respect to the amount treated as a dividend to Foreign LP on the redemption on its Foreign Bank stock under the Subpart F, foreign personal holding company or passive foreign investment company rules;
- Payments made by Investor to Limited Partner under the swap contract will not be subject to U.S. withholding tax.

It should be noted that our opinion is not binding upon either the Service or a reviewing court.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 11

IV. Analysis

A. Entity Classification of Foreign LP and General Partner

Recently finalized regulations under Code Section 7701, effective January 1, 1997, have simplified the task of classifying foreign business entities for U.S. federal income tax purposes. Under the new regulations, a business entity with two or more members is classified as either a corporation or partnership for U.S. federal income tax purposes. See Treas. Reg. Section 301.7701-2(a).

These rules require that certain foreign business entities be treated as *per se* corporations. Entities not designated as *per se* corporations are eligible to be treated as other than a corporation. See Treas. Reg. Section 301.7701-3(a). No type of Cayman Islands business entity is included on the list of *per se* foreign corporations under Treas. Reg. Section 301.7701-3(b)(8). Accordingly, the Cayman entities discussed in this opinion are entities eligible to choose their classification for U.S. federal income tax purposes.

The classification of a newly-formed eligible foreign business entity depends on whether the entity has more than one member, whether the entity offers all of its members limited liability and whether the entity elects something other than its "default" classification under the eligible entity rules. See Treas. Reg. Section 301.7701-3(b)(2). For example, if all members of an eligible foreign business entity have limited liability¹, the entity is classified by default as a corporation. See Treas. Reg. Section 301.7701-3(b)(2)(i). A newly-formed eligible entity, however, may elect classification other than that provided for by default in the new regulations. See Treas. Reg. Section 301.7701-

¹ For purposes of Treas. Reg. Section 301.7701-3(b)(2)(i), a member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability. Treas. Reg. Section 301.7701-3(b)(2)(ii).

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 12

3(c)(1)(ii). We have been advised by Cayman counsel that under Cayman Islands' law, pursuant to which Foreign LP and General Partner are organized, General Partner has unlimited liability for the debts of Foreign LP and the shareholders of General Partner have limited liability.

Under the default entity classification rules applicable to eligible foreign entities, a Cayman Islands "exempted company" would be classified as a corporation for U.S. federal income tax purposes. Accordingly, the default classification of General Partner, an "exempted company", is consistent with its intended classification for U.S. federal income tax purposes and no proactive election is required under Treas. Reg. Section 301.7701-3(c) on the part of either General Partner or its shareholders.

Since General Partner does not have limited liability with respect to the debts of Foreign LP, Foreign LP would be treated as a partnership under the default rules. In that the intended classification for Foreign LP is to be treated as a corporation for U.S. federal income tax purposes, an affirmative election is required. Based upon the affirmative election, Foreign LP will be treated as a "reverse hybrid". A reverse hybrid is a foreign legal entity that is treated as corporation for U.S. federal income tax purposes, but as a partnership under foreign corporate law.

Treas. Reg. Section 301.7701-3(c) prescribes a series of rules for filing Form 8832 to perfect elections for entity classification. As a general rule, an election made on Form 8832 is effective on the date specified on the form. However, the effective date specified on Form 8832 cannot be more than 75 days prior to the date on which the election is filed.

General Partner has represented to us that the election to treat Foreign LP as a corporation for U.S. federal income tax purposes was made effective the first day of its legal existence and a protective election has also been made with respect to General Partner's classification as a corporation for U.S. federal income tax purposes. Based upon General Partner's representations that the requisite elections under Treas. Reg. Section 301.7701-3(c) have been perfected, we are of the opinion that it is more likely than not that Foreign LP and General Partner will be classified as corporations for U.S. federal income tax purposes with respect to the transactions analyzed herein.

B. Redemption of Foreign LP's Foreign Bank Shares.

Investor
June 1, 1998
Page 13

1. Provisions of Code Section 302.

Code Section 302 governs the treatment of amounts received by a shareholder from a corporation in redemption of the corporation's stock. Code Section 302(a) provides that a redemption by a corporation of its own stock will be treated as a distribution in part or full payment in exchange for such stock if Code Section 302(b) applies. Otherwise, if the redemption fails to meet such tests, Code Section 302(d) provides that such redemption is treated as a distribution of property to which Code Section 301 applies.

A redemption entitled to exchange treatment under Code Section 302(a) will be reportable in accordance with Code Section 1001. Thus, if the redeemed stock is a capital asset in its hands, a stockholder will recognize capital gain or loss from the transaction. Alternatively, a redemption treated as a distribution under Code Section 302(d) will be treated as a dividend, and taxable as ordinary income, to the extent of the earnings and profits of the redeeming corporation.

Under Code Section 302(b), a redemption will be entitled to sale or exchange treatment under the following circumstances: (1) the redemption is "not essentially equivalent to a dividend," (2) the redemption is a "substantially disproportionate" redemption of stock, (3) the redemption completely terminates a shareholder's interest in the corporation, or (4) the redemption is from a noncorporate shareholder in partial liquidation of the corporation (which is not applicable to the instant case).

2. Stock ownership attribution rules of Code Section 318.

Code Section 302(c) provides that the stock ownership attribution rules of Code Section 318 apply, with exceptions not relevant here, in determining the ownership of stock for purposes of Code Section 302. Code Section 318(a)(5)(A) provides that, with certain exceptions not relevant in the instant case, a person who is deemed to own stock under the Code Section 318 attribution rules is considered to actually own such stock for purposes of further applying such rules.

Code Section 318(a)(4) provides that a person who owns an option to acquire stock shall be considered as owning such stock. Accordingly, Investor is treated as owning the

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 14

same number of Foreign Bank shares that it has the right to acquire under options in addition to the shares it actually owns.

Neither the Code nor the regulations discuss the required characteristics for an option to be subject to attribution under Code Section 318(a)(4). In Rev. Rul. 68-601, 1968-2 C.B. 124, the Service ruled that warrants and convertible debt are options within the meaning of Code Section 318(a)(4) and must be taken into consideration in determining whether a redemption qualifies as substantially disproportionate within the meaning of Code Section 302(b)(2). Even though the pronouncement was respect to the treatment of warrants and convertible debt, it is instructive in that it discusses the characteristics necessary to be subject to the attribution rules under Code Section 318(a)(4). Under the logic of Rev. Rul. 68-601, a warrant is treated as an option for purposes of option attribution based upon the following criteria:

In order for a warrant to acquire stock to qualify as an option, the holder must have the right to obtain the stock at his election. When this right to acquire stock exists, warrants or convertible debentures are not realistically different from options...In each instance, stock may be acquired at the election of the shareholder and there exist no contingencies with respect to such election.

This logic should extend to the instant case in that warrants are options to acquire stock that is issued directly by the corporation that is subject to the options. In general, warrants are effectively call options issued by the corporation itself rather than by a third party option writer. Consequently, the criterion discussed in Rev. Rul. 68-601 should apply equally to the instant case.

Rev. Rul. 89-64, 1989-1 C.B. 91, further clarifies that the use of the term "at his election" in Rev. Rul. 68-601 is to distinguish an option from a bilateral contract. The time of exercise has no bearing on this issue; an option satisfies the requirements of Code Section 318(a)(4) even though it is only exercisable after a period of time has lapsed. As to contingencies, a stock right does not constitute an option where the right is dependent on contingencies not within the control of the buyer. In GCM 35176 (12/19/72), it was held that a contingency that was a serious condition precedent which could result in substantial risk of forfeiture of the right to exercise would negate option attribution. An example of a sufficiently serious condition precedent is contained in Letter Ruling 8908062 (11/30/88) where convertible debt did not qualify as an option since it could be

Investor
June 1, 1998
Page 15

converted only after the issuing entity had successfully completed a primary public offering. In the instant case, the election to exercise the option in General Partner is solely at the discretion of Investor and there are no contingencies beyond the control of Investor.

Rev. Rul. 68-601 also provides that unissued stock covered by options/warrants owned by a person (e.g., Investor) unrelated to the redeeming shareholder (e.g., Foreign LP), may not be considered outstanding in the context of a redemption. See also Northwestern Steel & Supply Co., 60 T.C. 356 (1973), reaching the same conclusion under Code Section 1563. However, the Tenth and Sixth Circuits in Soren v. Commissioner, 334 F. 2d 275 (1964) and Patterson Trust, 729 F. 2d 1089 (1984) have both held to the contrary. Both cases were Code Section 302(b) cases and both held that option shares held by unrelated parties were considered outstanding before and after a redemption.

Under Code Section 318(a)(3)(C), a corporation is deemed to own all stock owned directly or indirectly by any person that owns 50% or more of the value of its stock. Accordingly, because Investor is deemed to own 50% of the shares of General Partner through Investor's option in General Partner under Code Section 318(a)(4), the Foreign Bank shares owned by Investor directly and through option attribution will be deemed to be owned by General Partner. In addition Treas. Reg. Section 1.318-1(b)(3) states in determining the 50% requirement of Code Sections 318(a)(2)(C) and (3)(C) all of the stock owned actually and constructively by the person concerned shall be aggregated. Accordingly, since Limited Partner owns 100 percent of General Partner, General Partner is considered to own 100 percent of Foreign LP—10% directly and 90% based upon an application of Code Section 318(a)(3)(C). Accordingly, all the Foreign Bank shares deemed owned by General Partner are considered to be owned by Foreign LP.

In summary, Foreign LP is deemed to own all of the Foreign Bank shares that Investor actually owns and those Investor is deemed to own under Code Section 318(a)(4). Consequently, based upon an application of the Code Section 318 attribution rules, after the redemption of its Foreign Bank shares Foreign LP will be deemed to own at least as many Foreign Bank shares as it owned before the redemption. Therefore, the redemption of Foreign LP's Foreign Bank shares should not qualify under Code Section 302(b)(3) as a complete termination of Foreign LP's interest in Foreign Bank or as a substantially disproportionate redemption under Code Section 302(b)(2).

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 16

In U.S. v. Davis, 397 U.S. 301 (1970), the Supreme Court held that the Code Section 318 attribution rules must be applied to a Code Section 302(b)(1) analysis (redemption "not essentially equivalent to a dividend"). The Court also determined that Code Section 318 attribution applied to Code Sections 302(b)(2) and (3) situations (redemption is "substantially disproportionate" or a "complete termination of shareholder's interest"). Significantly, Davis goes on to hold that the presence or absence of a tax avoidance motive should not be considered when evaluating dividend equivalency against the standards of Code Section 302(b)(1). This logic should also hold true for other types of redemptions. The Service has cited Davis in a number of rulings including Rev. Rul. 80-26, 1980-1 C.B. 66, and Rev. Rul. 81-289, 1981-2 C.B. 66, signifying its agreement with the Court's holdings in Davis.⁸

In Davis, the Court also stated that in order to avoid dividend equivalency under Code Section 302(b)(1), the redemption must result in a "meaningful reduction of the shareholder's proportionate interest in the corporation." The idea that a redemption must result in a "meaningful reduction" in the taxpayer's proportionate interest in the redeeming company has been widely embraced by the courts and the Service. (See GCM 38357 (4/21/80) for a list of subsequent cases and rulings citing Davis.) Although the term "meaningful reduction" remains imprecisely defined, many of the post-Davis Code Section 302(b)(1) decisions focus on the criteria established earlier in the case of Himmel v. Commissioner, 338 F.2d 815 (2d. Cir. 1964). In Himmel, the court looked to the following three rights: (1) the right to vote and thereby exercise control, (2) the right

⁸ Notwithstanding the Davis decision, in Halt Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975), rev'g and remanding 61 T.C. 398 (1973), the Court held that the attribution rules should be disregarded in testing the redemption of the taxpayers' stock for dividend equivalency because of family hostility. The Court reasoned that the attribution rules had a presumption of controlling influence over corporate affairs, and accordingly, family discord negated the presumption. However, in Rev. Rul. 80-26, 1980-1 C.B. 66, the Service ruled that it will not follow the decision in Halt. The Service reasoned that such an interpretation of the mechanical attribution rules was inconsistent with both the legislative history of Code Section 318 and the language and rationale in Davis. The Service pointed out that the purpose of the attribution rules under Code Section 318 was to replace the confusion of prior law with objective standards for attribution of stock ownership among related shareholders. Thus, the Service concluded that the facts and circumstances of a particular case cannot contradict the mechanical determination under Code Section 318 of how much stock a shareholder owns.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 17

to participate in current and accumulated surplus, and (3) the right to share in net assets on liquidation.⁹

The Service has clarified that a necessary prerequisite to any application of the Davis "meaningful reduction" standard is that a proportionate reduction in stock ownership must in fact occur. In Rev. Rul. 81-289, 1981-2 C.B. 82, the Service analyzed the effect of a shareholder's acceptance of a tender offer with respect to a portion of the less than one percent stock ownership interest he held in a publicly traded corporation. As a result of accepting a tender offer, although the number of shares owned by the taxpayer declined, his proportionate ownership in the corporation did not. The Service held that because there had been no reduction in the shareholder's proportionate interest, there could not, by definition, have been a "meaningful" reduction.¹⁰

⁹ For example, based on specific facts and circumstances, the Service concluded in one ruling that a reduction in the shareholding of a very minor shareholder in a public company is not essentially equivalent to a dividend. See Rev. Rul. 79-385, 1979-2 C.B. 92. In the ruling, a public tender offer resulted in the redemption of several hundred shares held by one of two related parties, out of 28 million outstanding. Due to attribution from the related party (which did not tender), the selling shareholder's interest in the redeeming company declined by only 3.3 % as a result of the redemption. The ruling concluded that the redemption was "not essentially equivalent to a dividend", (i.e., there had been a "meaningful reduction" in interest.). In the ruling, the Service observed that Congress, in enacting Code Section 302(b)(1), intended to grant capital gain treatment for redemptions by minority shareholders of preferred stock who exercised no control over corporate affairs. In extending this concept to small minority common stock holders, the Service citing Davis, argued that the taxpayer had experienced a reduction of its voting rights, its right to participate in current earnings and accumulated surplus, and its right to share in a liquidation. Presumably, given the ruling's conclusion, the Service concluded that these very modest reductions in the taxpayer's rights were nonetheless "meaningful" under the circumstances.

¹⁰ As originally drafted, this ruling had concluded that the shareholder had experienced a meaningful "change" in its rights as a shareholder and held that the redemption should be treated as not essentially equivalent to a dividend. GCM 38357, supra. In GCM 38357, however, the Service's Interpretative Division rejected this clear departure from the Davis meaningful reduction standard. In pointing out that the shareholder in question had in fact experienced no change in his proportionate interest in the corporation, the GCM observed that, where no such change has occurred, "dividend treatment must apply because not only is there no meaningful reduction, there is no reduction at all." *Id.*, italics added. See also GCM 39290, January 4, 1984, at footnote 4. The published version of Rev. Rul. 81-289, which embraces in substantial part the legal theory outlined in GCM 38357, is based upon the actual stock ownership of the shareholder in question (i.e., in the absence of any attribution of stock ownership under Code Section 318). It is clear from the logic of GCM 38357, however, consistent with the Supreme Court's holding in Estate of Howell,¹¹ that the threshold issue of whether an actual reduction in proportionate stock ownership has occurred must be addressed on the basis of both actual and constructive stock ownership in situations where Code Section 318 applies.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 18

As a result of the application of the Code Section 318 attribution rules, Foreign LP will be treated, for purposes of Code Section 302, as owning at least the same number of shares and, thus, the same proportionate percentage in Foreign Bank after the redemption of its Foreign Bank stock. In addition, the redemption could not have resulted in any "meaningful reduction" within the meaning of *Davis* because the redemption failed to produce any reduction in Foreign LP's proportionate interest in Foreign Bank. See Rev. Rul. 81-289, 1981-2 C.B. 82. Consequently, based upon the foregoing analysis, we are of the opinion that it is more likely than not that the redemption by Foreign Bank of its shares held by Foreign LP will fail to qualify as a redemption described in Code Sections 302(b)(1), (b)(2), or (b)(3). Accordingly, it is more likely than not that the redemption by Foreign Bank of its shares held by Foreign LP will be treated for U.S. federal income tax purposes, pursuant to Code Section 302(d), as a dividend distribution from Foreign Bank to Foreign LP by operation of Code Sections 301(a) and (c).¹¹

C. Increase in Investor's Basis in its Foreign Bank Stock

Under the Code Section 318 analysis discussed above, after the redemption Foreign LP should be considered to own the same number of Foreign Bank shares it owned prior to the redemption. However, after the redemption Foreign LP owned no Foreign Bank shares directly. Moreover, because the redemption of Foreign LP's Foreign Bank shares should be treated as a distribution of a dividend for U.S. federal income tax purposes, Foreign LP's basis in those shares will not be recovered as would have been the result in a sale or exchange. Consequently, this basis should be accounted for in some equitable manner.

Treas. Reg. Section 1.302-2(c) provides that when stock is redeemed in a transaction which is characterized as a deemed distribution, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed. Generally, where a shareholder has a portion of his shares redeemed and the redemption does not qualify for exchange treatment, the basis of the shares surrendered is added to the basis of the remaining shares. Where a shareholder surrenders all of his shares, but dividend

¹¹ The remaining dividend income is included in the taxable income of Foreign LP and allocated to Limited Partner and General Partner in accordance with their profit interest as described in the Foreign LP agreement.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 19

treatment is still accorded as a result of the Code Section 318 attribution rules, there are two conceivable alternatives relative to the taxpayer's basis in the shares: such basis could be transferred to the shares of the related party whose attributive ownership caused the redemption to fail to qualify as an exchange or the basis could merely disappear.

Although no case has directly addressed this issue, dicta contained in Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967) and Coyte v. U.S., 415 F.2d 488 (4th Cir. 1968) indicates that the residual basis should be allocated to the shares owned by the related party whose attributive ownership caused the redemption to fail to qualify as an exchange. In Levin, all of the taxpayer's stock was redeemed but, due to attribution from her son, the taxpayer was treated as having received a dividend. The court stated that "her basis does not disappear, it simply is transferred to her son." In Coyte, involving a Code Section 304(a)(1) constructive redemption, the redeemed shareholder actually owned no stock in the "brother" corporation which purchased his stock in the "sister" corporation. His ownership of the buying corporation was entirely constructive from his sons. In that the redemption was dividend-equivalent, the court stated that two reasonable solutions were to increase the sons' stock basis pro rata in the "brother" corporation or to increase the distributee's basis in his remaining "sister" corporation stock. In any event, the court indicated that the taxpayer's basis would not disappear.¹²

Example (2) of Treas. Reg. Section 1.302-2(c) indicates that the basis of the surrendered stock is allocated to the person whose stock was attributed to the distributee. In the example, Husband and Wife each owned 50% of the stock of Corporation. Husband's entire direct holding is redeemed by Corporation in a deemed distribution and the basis of Husband's redeemed shares is added to Wife's basis in her shares of Corporation. The regulation, as illustrated in Example 2, conveys the principle that the otherwise "disappearing basis" in such situations should shift to the stock held by the

¹² In a highly controversial ruling, Rev. Rul. 70-496, 1970-2 C.B. 74, the Service took the position in the context of a Code Section 304 transaction that the basis of the shares surrendered disappeared. However, in a subsequent private letter ruling, LTR 8239015 (6/25/82), where a redemption of a trust's shares was a distribution under Code Section 301 because the beneficiary's stock ownership was attributable to the trust, the Service held that the basis of the shares surrendered by the trust was added to the basis of the shares owned by its beneficiary. The amendments made to Code Section 304 in The Taxpayer Relief Act of 1997 effectively overrule the position taken by the Service in Rev. Rul. 70-496 by providing that the basis in the surrendered stock does not disappear, but instead allows the transferor corporation to be treated as acquiring basis in the transaction.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 20

other shareholder(s) whose stock ownership in the redeeming corporation, through the operation of Code Section 318, caused the redemption to fail exchange treatment under Code Section 302(b).¹³

As to what constitutes a "proper adjustment of the basis of the remaining stock", we believe the better view is that such basis should be transferred to the shares of the related party whose attributive ownership caused the redemption to fail to qualify as an exchange.¹⁴ In the instant case, Investor is the person whose stock ownership in Foreign Bank is attributed to Foreign LP thereby causing Foreign LP to be subject to dividend treatment on the redemption.

Accordingly, based upon the foregoing authorities and the representations that Investor was the only person, with a relationship in Foreign LP described in the Code Section 318 attribution rules, that owned Foreign bank shares directly or through options, we are of the opinion that it is more likely than not that Foreign LP's basis in its

¹³ Noted commentators also have endorsed this approach. Professors Bittker and Eustice have observed that:

"If the shareholder retains no shares after the redemption, the regulations sanction a transfer of the basis to the shares of a related taxpayer, at least if those shares were attributed to the redeemed shareholder and were, therefore, responsible for the seller's inability to offset the basis of the redeemed shares against the amount received for them. Ordinarily, the transfer of the redeemed shareholder's basis to shares owned by a related person is a reasonable adjustment." B. Bittker and J. Eustice, Federal Income Taxation of Corporations and Shareholders at ¶ 9.22(2) (6th ed. 1997) (footnotes omitted).

¹⁴ However, it should be noted that the term "proper adjustment" in Treas. Reg. Section 1.302-3(c) could be interpreted by the Service to mean that Investor should receive an adjustment to its basis in its own Foreign Bank shares (the basis effectively disappears), despite the fact that it was Investor's Foreign Bank shares and options that caused the redemption to fail exchange treatment under Code Section 302(b). For example, the Service could take the position that there should be no basis adjustment since Foreign LP did not have to include the deemed dividend in gross income. We believe that such an interpretation would be incorrect. There is no requirement under Code Section 302 that a shareholder recognize income as a result of the redemption in order for there to be made a "proper adjustment of the basis of the remaining stock". Prior to 1984, a common strategy for corporate taxpayers was to shelter a substantial portion of redemption proceeds through the dividend-received deduction under Code Section 243 and then allocate the basis in the redeemed shares to the remaining shares held. To address this perceived "abuse", Congress enacted Code Section 1059 which requires a corporate shareholder to reduce its basis in stock by an amount equal to the untaxed portion of certain dividends. In enacting Code Section 1059, Congress effectively acknowledged that income recognition is not required in order to effect a "basis shift" from redeemed shares to remaining stock.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 21

redeemed Foreign Bank shares should be allocated to Investor's Foreign Bank shares and potentially to Investor's Foreign Bank options.

Under Code Section 318(a)(5), an option that is constructively treated as stock is treated as stock actually owned by a shareholder for purposes of reattributing that stock to another person under Code Section 318. A literal reading of Treas. Reg. Section 1.302-2(c) indicates that Foreign LP's basis should be added to other Foreign Bank shares, since Code Section 318 applies generally to Code Section 302. However, under Code Section 318(a)(5), Investor's option on Foreign Bank shares could also be treated as stock for purposes of applying Treas. Reg. Section 1.302-2(c).

Thus, it is unclear as to whether all of the Foreign LP basis directly increases the basis in Investor's Foreign Bank shares, or if any of the basis is added to Investor's Foreign Bank options. Although not specifically sanctioned by the regulations, it is logical to assume that a portion of this basis should be allocated to the Foreign Bank options. Under Treas. Reg. Section 1.61-6, when a taxpayer disposes of property that is part of a greater whole, the basis of the whole is allocated between the part sold and the part retained in proportion to their relative fair market values. Hence, we believe that a reasonable interpretation of the rules indicates that Investor should allocate the basis arising from the redemption of Foreign LP's Foreign Bank stock between the Foreign Bank shares and the Foreign Bank options owned by Investor based on relative fair market values.

D. No Income to Investor from Redemption

1. Investor's Interest in Foreign LP

a. General Overview of Alternative Tax Treatments

Investor effectively has a derivative interest in Foreign LP as a result of having entered into the swap transaction. The swap requires Limited Partner to make a payment to Investor based on an amount which equates to Limited Partner's positive return from its interest in Foreign LP in return for periodic payments from Investor which are equal to an interest rate index times the notional principal amount. Such an arrangement could potentially be categorized as a cash-settled forward contract, a contingent debt instrument or a notional principal contract for U.S. federal income tax purposes, or

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 22

alternatively as an equity interest in Foreign LP.¹⁵ The primary reason that the Code distinguishes between the alternative categorizations is that whereas each of the three financial instruments possess effectively the same economic characteristics, each instrument is taxed differently for U.S. federal income tax purposes. As to tax outcome, the key conceptual differences between the three financial instruments are generally the character of resulting income and the necessity of accruing for an interest component. However, because the swap has a life of less than one year, the character of income generated is a lesser issue (there is no potential of long-term capital gain) and, as discussed below, there is no requirement to account for an interest component when financial contracts are of a duration of less than one year.

Under a cash-settled forward contract, the purchaser of the contract is entitled to receive a payment on the forward date equal to the spot price of the underlying property. A cash-settled prepaid forward contract can be viewed from an economic perspective as a loan from the purchaser of the contract to the seller, the repayment of which is wholly contingent upon the spot price of the underlying property on the forward date. The tax treatment of a prepaid forward contract is the same as the tax treatment of a nonprepaid forward contract. The tax rules do not take into account the fact that a portion of the proceeds has an embedded interest factor. Under Code Section 1234A, the character of the gain or loss attributable to the cancellation, lapse, or other termination of a forward contract on any capital asset is capital.

Contingent debt instruments can provide for contingent interest and guaranteed principal, contingent principal and guaranteed interest, or contingent interest and principal. The categorization most akin to the swap in the instant case is one where both interest and debt are contingent. The regulations under Code Sections 1271 through 1275 define the manner in which contingent debt instruments are taxed. The intent of these regulations is to define the treatment of contingent debt instruments in a manner

¹⁵ A prepaid forward contract is a privately-negotiated, unregulated executory contract that entitles the purchaser to delivery of the underlying property (or its cash equivalent in the case of a cash-settled prepaid forward) on a specified date in the future and requires the purchaser to pay for the underlying property at the time the contract is executed. A contingent debt instrument is a promissory note, the repayment of the principal and/or interest on which is contingent upon the value of the underlying property. A notional principal contract in the form of an equity swap is basically a bilateral contract that provides for periodic payments which replicate the financial returns generated by an ownership interest in the underlying property.

Investor
June 1, 1998
Page 23

consistent with the Original Issue Discount (OID) rules. Accordingly, the focus is upon the appropriate methodology for accruing interest deductions and interest income over the time period covered by the instrument. However, these provisions only apply to instruments that are debt instruments for U.S. federal income tax purposes. To the extent that an instrument should be treated as a forward contract, notional principal contract, option or some other financial arrangement, the logic of the regulations is that tax rules applicable to the tax treatment of these financial instruments should be applied.

The regulations under Code Section 446 define notional principal contracts as financial instruments that provide for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. See Treas. Reg. Section 1.446-3(c). Accordingly, a notional principal contract is a financial instrument that provides for "the payment of amounts" by one party to another. At least one party must have an obligation to make more than one payment if the conditions of the contract are satisfied. It is not necessary that any party actually make more than one payment, as long as at least one party would be obligated to make multiple payments if certain conditions were to occur. Under the terms of the swap in the instant case, Investor was required to make two quarterly payments¹⁸ and Limited Partner's payment

¹⁸ The notional principal contract regulations categorize payments made or received with respect to a notional principal contract as either periodic payments, nonperiodic payments or termination payments. Annually, a party to a notional principal contract must include as income or deduction the net amount of all periodic and nonperiodic payments recognized for the taxable year. Periodic payments are recognized under a callable daily accrual method, while nonperiodic payments are recognized under a method that requires amortization of the payment over the life of the notional principal contract. If the nonperiodic payment is "significant" (as upfront payment or prepayment would be considered significant), the parties to the notional principal contract must effectively treat the notional principal contract as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap component whereby the time value of money component associated with the loan is not included in the net income or net deduction from the swap, but is recognized as interest for all purposes of the Code. See Treas. Reg. Section 1.446-3(g)(4).

Periodic payments are defined by Treas. Reg. Section 1.446-3(e)(1) as "payments made or received pursuant to a notional principal contract that are payable at intervals of one year or less during the entire term of the contract (including any extension periods provided for in the contract), that are based on a specified index, and that are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments."

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 24

to Investor was payable at termination of the swap. Consequently, the multiple payment requirement under Treas. Reg. Section 1.446-3(c) is satisfied. In addition to the requirement for multiple payments, at least one party's payments must be made by reference to a specified index. Investor's payment is tied to a LIBOR index. The notional principal contract regulations provide that a contract described in Code Section 1256(b), a futures contract, a forward contract, an option or a debt instrument is not a notional principal contract. See Treas. Reg. Section 1.446-3(c)(1).

b. Tax Ownership in the Context of Financial Instruments

In addition to the potential of being treated as one of the above three types of financial instruments, the Service could also take the position that, although Investor has no direct ownership interest in Foreign LP, its interest is in substance an equity interest based upon a "substance over form" argument. Whereas categorizing the swap as either a notional principal contract, a cash-settled forward contract or a contingent debt instrument would not materially impact the tax results accruing to Investor, designation of Investor's interest as an equity investment would materially alter the tax results (e.g., see subsequent discussion under Section 2 analyzing the implications of Investor's interest in General Partner). An example of the Service asserting a "substance over form" argument against the taxpayer was its position in Rev. Rul. 82-150, 1982-2 C.B. 110, with respect to a deep-in-the-money American-style option.

The following is a discussion of the relevant statutory and judicial authorities which we believe provides the requisite support for the conclusion that it is more likely than not that the swap should not be recharacterized as an equity investment in Foreign LP by Investor.

Nonperiodic payments are all payments pursuant to a notional principal contract other than periodic payments or termination payments. See Treas. Reg. Section 1.446-3(f)(1). In most cases, the distinction between a periodic and a nonperiodic payment is evident. If, as in the instant case, a notional principal contract has a term of one year or less, all payments will satisfy the periodic payments requirement of being made at intervals of one year or less. In that the regulations ignore time value of money issues with respect to payments made at intervals of one year or less, the categorization of the prepayment by Investor as a "significant" nonperiodic payment would not result in the need to accrue an interest element.

In the context of nonfungible assets, the case law (most of which relates to sale-leasebacks) generally concludes that a relative weighing of economic benefits and burdens determines tax ownership. A derivative arrangement represented by the lease of tangible personal or real property would involve a scenario whereby title, which is retained by the lessor, is separated from possession and control, which is transferred to the lessee. The authorities in the sale-leaseback area generally conclude that a taxpayer who holds title to or maintains possession and control over property (but not both) may avoid tax ownership if title or control and a significant amount of the economic benefits and burdens reside with the counterparty.¹⁷

The Supreme Court in Frank Lyon Co. v. United States, 435 U.S. 561 (1978), considered multiple factors in reaching the conclusion that the nominal owner of the property was also the tax owner of the property, without indicating which of those factors was critical to the economic substance analysis. In determining whether a sale occurred in Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), the Tax Court delineated the following relevant benefits and burdens:

- whether legal title passes
- how the parties treat the transaction
- whether an equity interest was acquired in the property
- whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments
- whether the rights of possession are vested in the purchaser
- which party pays the property taxes
- which party bears the risk of loss or damage to the property

¹⁷ The seminal case in this area is Frank Lyon v. United States, 435 U.S. 561 (1978), where the Supreme Court concluded that ownership depends on "economic substance".

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 26

- which party receives the profits from the operation and sale of the property

The Tax Court concluded that the passage of benefits and burdens was the key factor in finding a sale transaction in Giroh & McKay. The Tax Court and other courts have subsequently used the above factors in determining whether there has been a sale.¹⁸ As was the case in Giroh & McKay, risk of loss and opportunity for profit is the predominant theme in these cases.

More recently, the question of tax ownership has been re-examined in the context of ownership of publicly-traded assets where, under the securities loan authorities, the relative economic benefits and burdens are deemed to be all but irrelevant. The following discussion concludes that, regardless of the categorization of the asset (fungible versus nonfungible), the overriding prerequisites for tax ownership are possession of title and control. If the taxpayer has neither and both attributes are vested with one or more unrelated persons, the taxpayer is not the tax owner. Only when title or control is split between two or more taxpayers do relative economic benefits and burdens become relevant. The primary authorities supporting this conclusion are those dealing with securities loans and forward contracts.

With respect to securities loans, a securities lender that does not possess either title or control over any specific security is not its tax owner, notwithstanding the lender's retention of substantially all of the benefits and burdens of ownership. The predominant importance of title and control over a specific security to determine its tax owner allows the lender to have virtually all of the economic benefits and burdens and the right to obtain title to and control over a generic security without being treated as the security's tax owner. As to forward contracts, a taxpayer that is not the titleholder and does not exercise control over an asset is not its tax owner, notwithstanding the taxpayer's ability to acquire title to and possession of a specific (unique) asset on a certain date; and the effective retention of substantially all of the asset's economic benefits and burdens during the term of the contract. Even though there is a certainty that the taxpayer will acquire title and control of the asset (assuming that the option is not cash-settled), before that time both reside in another party.

¹⁸ See, e.g., Bailey v. Commissioner, 912 F.2d 44 (2d Cir. 1990); Benedict v. United States, 881 F. Supp. 1532 (D.C. Utah 1995).

Investor
June 1, 1998
Page 27

The conclusion that a taxpayer can transfer economic benefits and burdens to another party and yet maintain tax ownership is effectively validated by the recent enactment of Code Section 1259. The provision treats a taxpayer that holds securities and enters into an offsetting position as "constructively", not actually, selling the securities, and then as "constructively", not actually, repurchasing the securities. Prior to the enactment of Code Section 1259, the classic example of a transaction where the taxpayer was able to transfer the economic risks of holding a financial instrument while maintaining tax ownership was the short sale "against the box." In this transaction, the holder of an appreciated security borrows and sells an identical security, while retaining the one he already had. By holding two precisely offsetting positions, one short and the other long, the taxpayer was insulated from fluctuations in the security's value. The holder could then extract cash by borrowing up to 95 percent of the proceeds of the short sale from the broker.

The constructive sales provisions, as initially proposed, would have applied whenever a taxpayer executed a transaction that, when considered in conjunction with a related long position, eliminated (with respect to the long position) substantially all of the risk of loss and the opportunity for gain. Code Section 1259, as enacted, explicitly enumerates the trades that lead to a constructive sale and delegates to the Treasury the authority to specify other trades that are deemed to have "substantially the same tax effect."¹⁹ The transactions that Congress clearly intended to treat as constructive sales were short-against-the-box transactions, equity swaps and forward sales because these transactions can be used to eliminate substantially all risk of loss and opportunity for gain.²⁰

¹⁹ The basic rule contained in Code Section 1259 is as follows: If a taxpayer makes a "constructive sale" of an "appreciated financial position," the taxpayer will recognize gain as if such position were sold at fair market value on the date of such constructive sale. An appreciated financial position is generally defined as any "position" with respect to stock, a debt instrument, or partnership interest if there would be gain if the position were sold, assigned or otherwise terminated at fair market value. A "position" is defined as an interest, including a futures or forward contract, a short sale, or an option. See Code Section 1259(b)(3).

²⁰ However, except for the short-against-the-box transaction, these transactions can also be structured with terms that leave the taxpayer with substantial risk of loss and opportunity for gain. For example, a taxpayer could enter into an equity swap that resembles a floor and a cap and that leaves the taxpayer with the risks and rewards of owning the stock to the extent the stock price remains between the cap and the floor. Accordingly, Congress had to define equity swaps and forward sales in a manner that clearly provides that they are covered under the statutory provision if they result in elimination of all, or substantially all, of the risk/reward associated with the appreciated financial position.

Investor
June 1, 1998
Page 28

In order for Code Section 1259 to apply, substantially all the risk of loss and opportunity for gain is eliminated. For example, an offsetting notional principal contract with respect to any property is defined as an agreement that includes "a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property" (emphasis added). Similarly, a forward contract is defined to mean a contract to deliver a substantially fixed amount of property for a substantially fixed price. See Code Section 1259(d).

c. Bifurcation of Economic and Legal Ownership - Examples

As in the instant case, there are a number of examples where the tax burdens of ownership exceed the benefits and a prospective investor will want to achieve economic exposure to a particular asset without assuming the tax consequence of ownership. The following discussion provides an overview of these opportunities where a taxpayer can achieve full economic exposure without being treated as its tax owner for U.S. federal income tax purposes.

Security Loans. Security loans are the best example of a taxpayer's ability to capture the economic benefits and burdens of ownership without being treated as an owner for federal income tax purposes. In a securities loan, the securities lender starts with physical securities and exchanges them for the contractual right to receive an identical amount of the same class of securities and "substitute" or "in-lieu-of" payments equal to the interest, dividends, and other distributions that the securities lender would otherwise have received (plus a borrow fee). Although the securities lender maintains all of the economic and burdens of ownership and the right to receive economically identical securities upon request (subject to the credit risk of the borrower), the securities lender is not treated as the owner of the loaned securities for federal income tax purposes. This treatment has been consistently reaffirmed by the Service and was ultimately ratified by Congress in 1978 when it added Code Section 1058 to the Code.²¹

²¹ See GCM 34948 (12/10/76); Rev. Rul. 80-135, 1980-1 C.B. 18 (substitute payments received on a loan of municipal bonds are not exempt from tax); Rev. Rul. 60-177, 1960-1 C.B. 9 (substitute payments received on a loan of stock are not dividends entitling lender to dividends-received deduction).

Investor
June 1, 1998
Page 29

Code Section 1058 presupposes an initial transfer for federal income tax purposes of the securities that are subject to the securities loan, and proposed regulations treat substitute payments not as actual dividends but as "a fee for the temporary use of property."²²

As to tax ownership, a taxpayer is no longer the tax owner of securities that are loaned pursuant to an agreement that legally deprives the lender of title and all right to receive back the specific securities transferred. The result effectively reflects the principle that if a taxpayer does not legally own an asset and has no right to obtain the asset, the taxpayer is not the owner, even if that asset is fungible with other assets that the taxpayer does have the contractual right to reacquire. As an economic matter, a securities lender's contractual right to receive identical securities from the borrower is subject to the borrower's credit risk, a distinction from actual ownership that is also important to tax ownership analysis in other contexts.

Total Return Equity Swaps. Under a standard total return equity swap arrangement, the taxpayer makes periodic payments, based on a notional amount, to its counterparty, and agrees to pay the depreciation, if any, in the underlying security on a periodic basis or at the maturity of the swap. In return, the counterparty agrees to pay the taxpayer periodic amounts equal to dividends paid on the underlying security and the appreciation, if any, in the underlying security on a periodic basis or at the maturity of the swap.

Although there is no direct authority on point, the threshold question of whether the equity swap triggers a taxable disposition of the long stock position has received considerable attention by the tax community. At least with respect to actively-traded securities, the consensus is that an equity swap should not cause the taxpayer to be treated as the tax owner of the underlying securities.²³ In general, such conclusion is

²² See Prop. Reg. Section 1.1058-1(d). To qualify for the benefits of Code Section 1058, the securities loan agreement must (1) provide for a return to the transferor of securities identical to the securities transferred, (2) require substitute payments equal to the payments on the securities, (3) not reduce the transferor's risk of loss or opportunity for gain in the securities transferred. Code Section 1058(b).

²³ See Nijmehuis, "Taxation of Notional Principal Contracts", in *Taxation of Financial Instruments*, Chapter 3 (1997); Kleinbard & Nijmehuis, "Short Sales and Short Sale Principles in Contemporary Applications" 53 *Ins. on Federal Taxation*, Section 7.02(2) (1995); Dolan & DuPuy, "Equity Derivatives: Principles and Practice", 13 *Va. Tax Review*, 161, 178-79; Freeman & Lipton, "Tax Consequences of Business and Investment-Driven Uses of Derivatives", 72 *Taxes* 947, 986-88 (1994); Ferguson, "The Rationales for the Rules: How to Think About Derivatives in the Tax World", 72 *Taxes* 995, 1013-14 (1994); Harrison.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
F. 30

based upon both the securities laws authorities and a comparison of the economic substance (the benefits and burdens) of holding the underlying securities directly and entering into an equity swap.

In contrast to a securities lender, the long party to a total return equity swap is never in a position to own the reference securities. A securities lender starts with the securities, receives amounts equal to dividends paid over the term of the security loan, and receives at termination of the loan securities that are economically identical to the original loaned securities. In contrast, the long equity swap participant never holds the underlying securities and is never entitled to receive physical securities.

The legal and economic substance of an equity swap participant's long position is different from an actual ownership interest in the underlying securities. A party to a long equity swap is not the titleholder to the underlying securities; does not have the right to obtain the physical securities (total return swaps are cash-settled); and has no legal rights with respect to the underlying securities, such as the right to vote the securities and the right to participate in a liquidating distribution. The swap participant is subject to real credit risk with respect to its counterparty. If payments on the swap do not match payments made on the underlying security, the swap participant can only look to the counterparty.

The Unfunded Promise to Pay Principle and Code Section 83. Code Section 83 is effectively based on the common law unfunded promise to pay principle. It allows a service provider who receives property in connection with the performance of services to control and exercise all rights with respect to the property and still escape tax ownership, so long as the property is subject to a substantial risk of forfeiture and transfer restrictions. Code Section 83(a) provides that until such property becomes substantially vested, the transferor shall be regarded as the owner of the property. For example, an employee who receives restricted stock of his employer, and yet has full voting rights and the right to receive dividends on the stock, is not treated as its owner until the restrictions lapse.

"Withholding on Cross-Border Stock Loans and Other Equity Derivatives," 72 Taxes 1050, 1057-58 (1994); Kleinbard, "Risky and Riskless Positions," 71 Taxes 781, (1993); Steinberg, "Selected Issues in the Taxation of Swaps, Structured Finance and Other Financial Products," 1 Fla. Tax Rev., 363 (1993).

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 31

Forward and Futures Contracts. The holder of a forward or futures contract to purchase property, who does not hold and cannot acquire title of or possess or control the property, is not generally treated as the owner of the property for federal income tax purposes prior to settlement.²⁴ In *Commissioner v. North Texas Lumber Co.*, 381 U.S. 11 (1930), the Supreme Court held that actual notification by one party of its exercise of an option, subject only to the ministerial act by other party of preparing the sales agreement, was insufficient to transfer ownership of the underlying property.²⁵ In addition, since the seller's performance is the trigger event for a sale, prepaid forward contracts equally do not convey ownership until their settlement.²⁶

Nongrantor Trusts. Nongrantor trusts are treated as separate and independent tax entities, and a taxpayer may avoid tax ownership of property by having it held by a nongrantor trust of which he is the sole beneficiary. The trade-off for this treatment is a significant restriction on the amount of control that the grantor may exercise over the property, under the specific rules for avoiding grantor trust status set forth under Code Sections 671 through 679. The nongrantor trust is subject to net income tax on accumulated income at maximum rates corresponding to rates applicable to individuals.

In *Helvering v. Clifford*, 309 U.S. 331 (1940), the taxpayer attempted to avoid tax ownership of certain securities he owned by contributing them to a trust established for the "exclusive benefit" of his wife. The trust instrument provided for income to be paid to his wife for a five year period and then for the trust to be terminated and the

²⁴ See *Comm. v. N. Texas Lumber Co.*, 381 U.S. 11 (1930) (executory sale of sawmill not closed until settlement); *Rich Lumber Co., Inc. v. United States*, 237 F.2d 424 (1st Cir. 1956) (same); *Stanley v. United States*, 430 F. Supp. 381 (N.D. Miss. 1977) (forward contract to buy convertible debentures not treated as ownership of debentures prior to settlement). *off'd per curiam*, 599 F.2d 672 (5th Cir. 1979); *Dahlquist v. Comm.*, 30 B.T.A. 176 (1930); ("Although a contract to sell is consummated when the parties execute it, a sale, even where the subject of a contract, is incomplete and imperfect until title passes."), *off'd*, 51 F.2d 662 (3d Cir. 1931); Rev. Rul. 79-294, 1979-2 C.B. 305 ("commodity futures contract is merely an executory contract,"; Rev. Rul. 74-227, 1974-1 C.B. 119 (ruling that a commodities dealer may not adjust year-end inventory to reflect unclosed futures contracts).)

²⁵ See also *Comm. v. Union Pacific R.R.*, 86 F.2d 637 (2d Cir. 1936) ("A closed transaction for tax purposes results from a contract of sale which is absolute and unconditional on the part of the seller to deliver to the buyer a deed upon payment of the consideration and by which the purchaser secures immediate possession and exercises all the rights of ownership.")

²⁶ See *Bourne v. Comm.*, 62 F.2d 648 (4th Cir. 1933); *Modesto Dev. Yard, Inc. v. Comm.*, 14 T.C. 374 (1950).

Proprietary Material
Confidentiality Requested

KPMG 0035733

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 32

corpus to revert back to the taxpayer. However, the taxpayer declared himself the trustee, and the trust instrument granted him the "absolute discretion" to reinvest or pay out the income to his wife and the ability to buy, sell, and vote the corpus. The Supreme Court held that the taxpayer had effectively retained all of the attributes of an owner and would be treated as the owner of the trust's assets. Although *Clifford* had been preempted by the grantor trust rules²⁷, it has been cited by courts as a basis for holding that a derivative holder with investment control is the tax owner of the underlying assets.²⁸

d. The Service's Position in Rev. Rul. 82-150 v. Cash-Settled Options

American-style options, which are exercisable at any time, do not generally convey ownership in the underlying property. However in Revenue Ruling 82-150, 1982-2 C.B. 110, the Service asserted substance over form arguments to treat a deep-in-the-money *physically settled* American-style option as actual tax ownership in the underlying property. The Service's reasoning behind the ruling is that in the case where a taxpayer bears all or substantially all of the economic benefits and burdens of an asset, the taxpayer is substantially certain to exercise the option, and the taxpayer can actually acquire title and possess the asset instantly for a relatively small amount, the taxpayer is the true tax owner. In effect, the ruling suggests that a benefits and burdens analysis is appropriate if title and control are lacking but can be acquired instantly for a payment that is nominal.

In contrast to the treatment of an American-style physically-settled option, if an European-style or solely cash-settled option is issued deep-in-the-money, it should be treated as a prepaid forward contract and not as a current ownership interest.²⁹ In such case, the holder of the option does not have the ability to obtain title to, possession, or control of the asset from the owner until maturity of an European-style option and in the case of a cash-settled option, he will never acquire these tenants of ownership. The same

²⁷ Under Code Sections 671, "No income of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust and under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart."

²⁸ See, e.g., *Christianson v. United States*, 749 F.2d 513, 515-16 (8th Cir. 1984), cert. denied 473 U.S. 902 (1985).

²⁹ See prior discussion of forward and future contracts.

Investor
June 1, 1998
Page 33

logic would hold true if there exists contractual barriers to acquiring the asset at will or if the counterparty's creditors can obtain the underlying assets upon the insolvency of the counterparty; the conclusion should be that the counterparty holds title to the asset.

e. Application of Tax Ownership Principles to the Swap

A financial market instrument that is similar to the economics of the swap instrument is a hedge fund swap. The general investment strategy of hedge funds is to move in and out of investments quickly. As a result the funds generate significant amounts of short-term capital gains which are taxed at ordinary income tax rates. By investing in a derivative security, hedge fund investors effectively convert such income generated by the fund into long-term capital gain. The returns from investing in the derivative security, in effect, mimic the returns generated by the hedge fund and are structured so as to generate long-term capital gain by delaying receipt.

The investment dealer that takes the other side of the contract, which is structured as a swap, usually invests in the hedge fund directly to offset its liability to the investor, though the contract typically does not require this. The transaction can also be structured as a combination of put and call options on hedge fund shares. Under both approaches, the dealer has effectively placed itself between the investor and the hedge fund – the investor is merely the holder of a swap contract. The contracts are structured so as to enable the investor to defer recognition of the hedge fund's short-term capital gains. At such time that the contract expires or terminates, Code Section 1254A, as amended by the Taxpayer Relief Act of 1997, provides that the payment the investor receives is treated as capital gain.³⁰

In a standard hedge fund swap an individual enters into an agreement with a dealer, using ISDA swap documentation, providing for the following stream of payments with respect to a notional interest in a hedge fund that is a partnership for U.S. federal income tax purposes. On a quarterly basis, individual pays dealer an amount equal to an interest rate multiplied by the notional interest principal amount and dealer will pay individual the value of any distributions that would have been received from the fund by the holder of the interest. At the end of the term of the swap, dealer pays individual any

³⁰ See Wall Street Journal, 10/21/97, p. C1, for article describing the current financial market structure for hedge fund swaps.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 34

appreciation in the value of the interest since inception of the swap and individual will pay dealer any decrease in the value of the interest since inception of the swap.

If investment in a hedge fund swap allows the individual investor two basic tax advantages relative to a direct investment in the partnership. The individual does not recognize the hedge fund income that would be allocable to a current owner of a partnership interest and the gain realized at maturity of the swap is taxed at long-term capital gains rates. The basis for not being viewed as holding a direct partnership interest is Rev. Rul. 77-137, 1977-1 C.B. 178. The ruling holds that where the assignee of a partnership interest could not, as a consequence of the partnership agreement, become a substitute limited partner, an agreement by the assignor to exercise all of its residual rights in favor of the assignee caused the assignor to acquire "dominion and control" over the partnership interest and to become the a substitute limited partner for tax purposes. GCM 36960 (12/20/76), which analyzes the issues underlying Rev. Rul. 77-137, emphasized the importance of an agreement by the assignor to exercise its residual rights, such as the right to vote and the right to inspect partnership books, in favor of the assignee. The GCM concludes that "in the absence of some specific provision for the exercise of these residual rights in favor of and solely in the interest of the assignee, the assignor should continue to be taxed on the partnership distributive shares as still having dominion and control over the assigned interest." In reaching this conclusion, the GCM relies on Reg. Section 1.704-1(e) and *Evans v. Comm.*, 447 F.2d 547 (7th Cir. 1971), *aff'd* 54 T.C. 40 (1970), *acq.*, 1978-2 C.B. 2.

In the instant case, the swap is structured as follows:

Counterparty A (Fixed Payor):	Investor
Counterparty B (Floating Payor):	Limited Partner
Notional Amount:	[Amount which equates to Foreign LP's long position in Foreign Bank stock]
Settlement:	Cash only
Term:	Six months

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 35

Fixed Payment: Two payments of 2.75% of Notional Amount, each payable quarterly in advance

Floating Payment: 90% of Counterparty B's distributive share of income and gain of Foreign LP, payable at termination of the contract. (If Foreign LP liquidates before the termination of the contract or the partnership assets have not been sold, the assets will be marked to market to determine the amount Counterparty B owes Counterparty A).

Security: Counterparty A: Pledge of investment grade securities to secure obligation to make second fixed payment.

Counterparty B: None. (The swap is an unsecured obligation of Limited Partner and imposed no limitation upon Limited Partner's ability to sell or otherwise dispose of its interest in Foreign LP).

Apart from Foreign LP being treated as a corporation for U.S. federal income tax purposes and investor not being required to make depreciation payments to Limited Partner, the swap in the instant case closely replicates the form and underlying economics of a standard hedge fund swap—a financial arrangement that is generally treated as a notional principal contract by the financial markets.

Based on the foregoing discussion and analysis, we believe that maintaining title and control over its interest in Foreign LP is generally a sufficient reason for concluding that Limited Partner remains the tax owner of the Foreign LP interest. However, the conclusion requires additional support because Limited Partner cannot directly control the activities of Foreign LP in light of its limited partner status. The conclusion can be buttressed by the following:

Proprietary Material
Confidentiality Requested

KPMG 0035737

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 36

- Limited Partner retains the right to vote its interest in Foreign LP, receive current distributions and participate in liquidating distributions;
- Limited Partner retains an unrestricted right to dispose of its interest in Foreign LP without the triggering of a payment requirement to the swap counterparty;
- The Foreign LP assets underlying Limited Partner's partnership interest are subject to Foreign Bank loan covenants;
- The swap, by definition, is cash-settled; accordingly, Limited Partner retains possession of its interest in Foreign LP and all associated rights of ownership at all times;
- Investor has the same rights regardless of whether Limited Partner owns the reference security.
- Investor bears the risk of Limited Partner's failure to make payment under the terms of the swap agreement.

We are of the opinion based upon the construct of the swap as an unsecured obligation of Limited Partner and the foregoing analysis of the rights that are maintained by Limited Partner that it is more likely than not that Limited Partner should not be considered as transferring tax ownership of its interest in Foreign LP to Investor as a result of engaging in the swap transaction. Consequently, none of the Foreign LP's income should be taxable to Investor based upon Investor having an ownership interest in Foreign LP.

f. Categorization of Swap Instrument

As discussed, the form and underlying economics of the swap closely approximate that of a notional principal contract, a cash-settled forward contract and a contingent debt instrument. In determining the most appropriate designation, two key distinguishing factors are the multiple payment requirement on the part of Investor and Investor's entitlement to Limited Partner's distributive share of income during the period covered by the swap agreement. With respect to the multiple payment requirement, this

Investor
June 1, 1998
Page 37

would, in effect, make the instrument a non-standard forward contract and a non-standard contingent debt instrument. In order to characterize the swap as either a forward contract or a contingent debt instrument, the issue price would have to be viewed as being paid on an installment basis. As to Investor's entitlement to both income and appreciation under the swap agreement, forward contracts and contingent debt instruments generally only entitle the holder of the derivative equity position with a return based solely upon appreciation in the underlying security.

In addition to these distinguishing factors, contingent debt characterization can be further distinguished in light of the Investor's inability to enforce the payment of principal and interest. (In order to be treated as a contingent debt instrument, Treas. Reg. Section 1.1275-4 provides that the contingent debt provisions only apply to instruments that are debt instruments for U.S. federal income tax purposes.)

In light of these differentiating factors, we believe that the better view is that it is more likely than not that the swap instrument should be treated as a notional principal contract for U.S. federal income tax purposes.

We believe that it is unlikely that the Service would attempt to treat the swap as a contingent debt instrument because of the short term nature of the instrument, six months. Under Code Section 1273(a)(2)(C), the OID rules do not apply to financial instruments with maturity dates of less than one year. In addition, the logic of the contingent debt regulations is that to the extent a financial instrument should be treated as a forward contract, notional principal contract, option or other financial arrangement, the tax rules applicable to the tax treatment of those financial instruments should be applied.

Additionally, we believe that it is unlikely that the Service would take the position that the tax implications of participating in the swap should be subject to Code Section 1234A rather than the notional principal regulations because designation as a notional principal contract would result in ordinary income characterization. In TAM 9730007 (7/25/97), the Service for the first time discussed the character of payments received under a swap contract. The Service concluded that the payments made under the terms of the swap discussed in the ruling were ordinary. The Service's reasoning was that periodic payments made pursuant to a swap are more similar to dividends or interest, which are ordinary, rather than amounts received on the sale or exchange of the

Investor
June 1, 1996
Page 38

underlying instrument. As a consequence, the Service concluded that a periodic payment under a notional principal contract is not the sale or exchange of a capital asset under Code Section 1222.

In the event the swap was treated as a cash-settled forward contract by the Service, generally the implications would not be significant in that the result would be short-term capital treatment for the net payment received by Investor. As such, the payments could be netted against other capital items. Code Section 1234A, as amended by the Taxpayer Relief Act of 1997, ensures that the payment the investor receives is treated as capital gain by extending the application of Code Section 1234A to all types of property, including contracts in non-actively traded personal property.

2. Investor's Interest in General Partner

In light of General Partner's classification as a corporation and Investor's ownership of an option in General Partner entitling Investor to 50% of its shares upon exercise, certain provisions of the Code must be examined to determine whether Investor is required to include in its income a portion of the dividend income earned by Foreign LP. Under the Foreign LP partnership agreement, General Partner must take into account 10% of all items of income, gain, deduction, loss or credit of Foreign LP, except for gains or losses derived from certain Foreign Bank shares for which General Partner must take into account 90% of such items. Whereas General Partner's entitlement to Foreign LP income is based upon the Foreign LP partnership agreement, General Partner is considered a shareholder in Foreign LP for U.S. federal income tax purposes. Accordingly, any distributions from Foreign LP to General Partner would constitute dividends for U.S. federal income tax purposes.

a. Applicability of the Subpart F and FPHC Provisions.

In general, foreign corporations are not subject to U.S. federal income tax unless such corporations receive certain income from U.S. sources or receive income that is effectively connected with a U.S. trade or business. In addition, U.S. shareholders of a foreign corporation generally are not subject to U.S. federal income tax with respect to a foreign corporation's business activities unless and until the shareholders receive dividends (or other payments) from the foreign corporation. Because this "deferral" principle could lead to certain abuses, legislation has been enacted under which the U.S.

Investor
June 1, 1998
Page 39

shareholders of foreign corporations may be subject to U.S. taxation on the foreign corporation's earnings prior to the payment of dividends. These anti-deferral regimes are described below as the controlled foreign corporation provisions, the foreign personal holding company provisions, and the passive foreign investment company provisions.

The intent of the Subpart F provisions under Code Sections 951-964 is to prevent U.S. persons from deferring recognition of certain foreign income from U.S. federal income taxation. This result is achieved by providing that Subpart F income earned by a controlled foreign corporation is deemed distributed to a U.S. person in an amount that "would have been distributed to such person had the foreign corporation distributed a dividend with respect to its stock" ..

Under Code Section 957(a), a foreign corporation is a controlled foreign corporation ("CFC") if (1) more than 50% of the total combined voting power or (2) more than 50% of the total value of the stock of such corporation is owned by one or more U.S. shareholders. Code Section 951(b) defines a U.S. shareholder as a U.S. person who owns 10% or more of the total combined voting power of a foreign corporation. Code Section 958(b) further provides that the constructive ownership rules of Code Section 318(a) (including the option exercise rule of Code Section 318(a)(4)) shall apply to the extent the effect is to treat a U.S. person as a U.S. shareholder or to treat a foreign corporation as a CFC. Investor's constructive ownership of 50% of General Partner through its option is not sufficient to result in General Partner being deemed a CFC. Because a foreign corporation is a CFC only if U.S. shareholders actually or constructively own greater than 50% of the voting power or value of a foreign corporation's stock, the option in General Partner should not cause General Partner to be deemed a CFC. See Code Section 958(b).

Even though a mechanical application of the ownership rules does not result in CFC status for General Partner, the Service could assert CFC status based upon a facts and circumstances argument. However, should the Service take this position, the option should not result in Investor including in its income any Subpart F income earned by General Partner because Investor did not have direct ownership of General Partner shares within the meaning of Code Section 958(a). Treas. Reg. Section 1.951-1(a)(2) provides that only those U.S. shareholders who "own (within the meaning of Code Section 958(a)) stock in such corporation on the last day" of the taxable year of the CFC must include in income that CFC's subpart F income. Code Section 958(a) provides that

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 40

"stock owned" means only stock owned directly and through foreign entities. Code Section 958(a) does not include stock constructively owned by application of Code Section 958(b).

Notwithstanding the fact that options are not typically treated as the equivalent of stock, in Rev. Rul. 82-150, 1982-2 C.B. 110, the Service held, based upon the facts and circumstances described in the ruling, that the purchase of an option to acquire stock was in substance a purchase of the stock itself for purposes of applying the Subpart F and foreign personal holding company rules. The basis for the Service's conclusion was that the exercise of the option was considered to be a virtual certainty. In the ruling, a foreign individual organized a foreign corporation by contributing 100,000x dollars in exchange for all of the authorized shares of the company. A U.S. person purchased an American-style call option from the foreign individual with respect to all of the outstanding shares for a premium of 70,000x dollars and a strike price of 30,000x dollars. The U.S. person effectively furnished all of the capital used by the foreign individual to fund the company (the 70,000x dollar premium and the deep-in-the-money strike price of 30,000x dollars).

The option on which the conclusion in Rev. Rul. 82-150 was based could be exercised at any time. The Service concluded that it was a virtual certainty that the U.S. person would exercise the option because the option allowed its holder to immediately purchase for 30,000x dollars an asset worth 100,000x dollars. The underlying economics of the option in the instant case are significantly different from those contained in the ruling because Investor could not exercise the option "at any time." Unlike the scenario in Rev. Rul. 82-150, the Investor's option could only be exercised 60 days after issuance.

In addition, it was not a virtual certainty that the option would be exercised. There were four alternative outcomes as to the disposition of the option by the Investor—the option could have been (1) exercised, (2) put back to Limited Partner by opting for the cash settlement feature, (3) sold to a third party or (4) the option could expire. Ultimately, in order to maximize its financial returns from participation in the investment strategy, Investor *[opted for the cash settlement feature or Investor has opted to allow the warrant to expire]*.

Investor was not required to exercise the option in order to obtain a cash settlement in light of the put feature. One could view the option as being akin to a non-

Investor
June 1, 1998
Page 41

standard (in light of the notification requirement) call option which can be either physically settled or cash settled.³¹ An investor effectively has a choice as far as monetizing his investment, he can purchase and sell the underlying security directly or alternatively he can purchase a call option with a cash settlement feature. Under current law, the two alternatives should be viewed as being independent.³²

Another key distinguishing factor is that the alternative of cash settlement negates the ability to have a Subpart F inclusion of income in the amount that "would have been distributed to such person had the foreign corporation distributed a dividend with respect to its stock". Investor has no right to dividends unless and until investor exercises its option for physical settlement in shares of General Partner stock. The option is strictly a unilateral contract in that investor can not be forced to exercise the option and take physical settlement in shares – investor can always opt for cash settlement of the option.

In addition to the multiple alternatives available to investor for settling the option, in the instant case unlike the facts in the ruling, the investor is not entitled to all the outstanding shares and is not providing 100 percent of the capital to General Partner. If the option is put back to Limited Partner pursuant to the cash settlement feature, the capital structure of General Partner does not change. There is the incentive to put the option in order to avoid the transaction costs associated with maintaining the existence of the company or alternatively the costs of liquidation.

³¹The concept of providing for either physical delivery or cash settlement based upon the fair market value of the underlying property is common. In fact, options on publicly traded property—in light of the underlying property being easily valued—tend to be cash settled, eliminating the need to incur transaction and associated settlement costs.

³²The preamble to the Proposed Regulations dealing with the treatment of stock rights under Code Sections 354, 355 and 356 issued in December 1996 invites comments on whether Section 302 should apply to the cash settlement or repurchase of a stock right. The Preamble to the Proposed Regulations suggests that the application of Code Section 302 to stock rights could be accomplished by viewing the holder of a cash-settled or repurchased stock right as "having purchased the stock pursuant to the terms of the right and the issuer as having then redeemed that stock for cash." This approach would be contrary to the prevailing view as to how the transaction should be construed and inconsistent with general tax principles. In addition, it would not be in accord with the actual terms of most cash-settled stock rights. In general, taxpayers are not treated as owning cash or property that they are under a binding obligation to immediately dispose of. See e.g., *American Russian Co. v. Comm.*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3 Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 42

Based on the foregoing, we are of the opinion that it is more likely than not that Investor should not be taxable under the Subpart F provisions with respect to the amount treated as a dividend to Foreign LP as result of the redemption of its Foreign Bank stock.

Code Sections 551-558, the foreign personal holding company ("FPHC") provisions, provide an additional set of anti-deferral rules which prevent U.S. persons from deferring the recognition of certain foreign income from U.S. federal income taxation. This result is achieved by providing that foreign personal holding company income is deemed distributed as a dividend to U.S. shareholders.

Under Code Section 552(a), a foreign personal holding company is any foreign corporation that meets certain income tests and for which at any time during a taxable year more than 50% of the total combined voting power or value of the stock of such corporation is owned directly or indirectly by or for 5 or fewer individuals who are citizens or residents of the United States. As in the case of determining whether a foreign corporation is a CFC, under Code Section 554(a), if any person has an option to acquire stock, such stock is considered as owned by such person. However, Investor's constructive ownership of 50% of General Partner through its option is not sufficient to result in General Partner being deemed a foreign personal holding company. Because a foreign corporation is a foreign personal holding company only if U.S. citizens or residents actually or constructively own greater than 50% of the voting power or value of a foreign corporation's stock, the option in General Partner should not cause General Partner to be deemed a foreign personal holding company. In addition, as in the case of a controlled foreign corporation, income is not deemed distributed as a dividend to a U.S. person who is merely the holder of an option on the stock of the foreign corporation. See Code Section 551(b) and Treas. Reg. Section 1.551-2(c).

Based upon the foregoing, it is more likely than not that Investor will not be required to include in its income under the foreign personal holding company rules the amount treated as a dividend to Foreign LP as result of the redemption of its Foreign Bank stock.

b. Applicability of the Passive Foreign Investment Companies Provisions

Code Sections 1291-1298 provide the tax rules applicable to U.S. persons owning stock in a passive foreign investment company ("PFIC"). Under this regime, unless a

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 43

U.S. person that owns stock in a PFIC elects to treat the PFIC as a qualified electing fund ("QEF"), when the U.S. person receives an "excess distribution" from a PFIC, the U.S. shareholder will incur U.S. tax on such excess distribution, plus an interest charge based on the value of the deferral realized from the investment. An "excess distribution" can result either from an actual distribution from a PFIC, or from a sale of shares or a liquidation of a PFIC, in which case, the special treatment of excess distributions extends to the gain recognized by the selling shareholder.

A foreign corporation is a PFIC for a given year if either (i) 75 percent or more of its gross income is passive income (the "income test"); or (ii) 50 percent or more of the average amount of its assets produce (or are held for the production of) passive income (the "asset test"). See Code Section 1297(a). The definition of passive income includes, subject to certain exceptions not relevant here, income that would be foreign personal holding company income as defined in Code Section 954(c). See Code Section 1297(b)(1).

Unless a shareholder has made a QEF election (described below), when PFIC stock is sold, the interest charge is determined by allocating the gain over the U.S. shareholder's holding period of the stock, imposing tax at the highest rate in effect for each tax year to which gain is allocated, and calculating interest on that unpaid tax. Under proposed Treasury regulations, if PFIC stock is acquired through the exercise of an option, the holding period of such stock includes the holding period of the option. See Prop. Reg. Section 1.1291-1(b)(3).

As noted, a shareholder of a PFIC may make an election to have the foreign corporation treated as a qualified electing fund ("QEF") with respect to the electing shareholder's stock. If a QEF election is made, such U.S. shareholder includes currently in gross income his pro rata share of the PFIC's earnings as a dividend. If a QEF election is not made, the U.S. shareholder is subject to the interest charge regime described above.

General Partner will be treated as a PFIC as a result of its portfolio investment in Foreign LP. However, since Investor does not have direct ownership of General Partner shares within the meaning of Code Section 1293(b) (in the case of a qualified electing fund) and does not hold stock for purposes of Code Section 1291(a)(1)(A) (in the case of a nonqualifying fund), we are of the opinion that it is more likely than not that Investor

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 44

should not have to include in income or pay a deferred amount under the PFIC provisions discussed.

Proposed Treasury regulations provide that the disposition of an option to acquire stock in a PFIC (other than by exercise of the conversion right³³) is treated as a disposition of stock in a PFIC. While these regulations are not yet effective, they would, if enacted in their present form, apply to dispositions which occur on or after April 11, 1992.³⁴ See Prop. Reg. Section 1.1291-1(d). Thus, to the extent the proposed regulations became effective in their present form, the PFIC provisions would generally apply to any gain realized from the disposition of the General Partner option (other than by exercise of the option) and an interest charge would be imposed by allocating the gain over the Investor's holding period of the General Partner stock, imposing tax at the highest rate in effect for each tax year to which gain is allocated, and calculating interest on that unpaid tax.³⁵

E. No Withholding on Swap Payments

As noted, we believe the most appropriate characterization of the swap for U.S. federal income tax purposes is its treatment as a notional principal contract. Code Section 1441 generally requires a 30% tax to be withheld from certain payments of U.S. source income to a foreign person. Treas. Reg. § 1.863-7(b) provides that the source of income from a notional principal contract is determined by the residence of the taxpayer under Code Section 988(a)(3)(B)(i). Code Section 988(a)(3)(B)(i) provides that the residence of an individual, such as Limited Partner, is the individual's tax home, unless the individual has a qualified business unit elsewhere. Limited Partner has represented

³³ It is important to note that even though the Proposed Treasury regulations provide that the exercise or conversion of an option is not treated as a disposition of stock for purposes of the PFIC rules, subsequent disposition of the stock acquired by exercising or converting an option would be subject to tax under the PFIC regime.

³⁴ No assurance can be given whether these regulations will be enacted, or if enacted, whether they will be enacted in their present form (including their effective date).

³⁵ The Taxpayer Relief Act of 1997 added Code Section 1296(e) to provide that for the portion of a shareholder's holding period that is after December 31, 1997 and during which the shareholder is a U.S. shareholder as defined under Code Section 951(b) (i.e., if the shareholder is subject to the current inclusion rules of Subpart F) and the corporation is a controlled foreign corporation, the corporation is not treated as a PFIC.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 45

that its tax home is not in the United States and Limited Partner does not have a qualified business unit in the United States.

Based on the foregoing, we are of the opinion that it is more likely than not that the payment made by Investor to Limited Partner under the swap should not be subject to U.S. withholding tax.

F. Other Tax Provisions and Judicial Doctrines

In arriving at our conclusions, we have considered several other Code provisions, as well as certain judicial doctrines which, if applicable, could impact the tax results of this transaction. These other Code provisions and doctrines are whether Foreign LP will be respected as a Foreign Bank shareholder; applicability of the step transaction, the agency, and the business purpose doctrines (including Code Sections 183(a) and 165(c)(2)); the possible invocation of Code Section 269; and the applicability of Code Sections 1059, 1091 and 465.

1. Foreign LP Should Be Treated as a Shareholder of Foreign Bank

a. Common Law Standard.

As described above, Foreign LP wrote barrier call options on 90% of its Foreign Bank share position that were 5% in the money. As barrier options, the original options "knock-out", or expire, if the trading price of the Foreign Bank stock drops below [DM price] prior to the option's expiration. A "knock-in" option is activated to replace the expired option with a strike price of [DM price]. Foreign LP also purchased put options on 100 percent of its Foreign Bank position that were 10% out of the money. When combined, these put and call options reduced Foreign LP's risk and potential benefits from its Foreign Bank share position. Therefore, an issue may arise regarding Foreign LP's ownership of the Foreign Bank shares for U.S. federal income tax purposes.²⁶

As discussed in the context of the swap instrument, an extensive body of case law and rulings has developed that addresses the question of tax ownership in the disparate

²⁶ We have been advised by Cayman counsel that Foreign LP is treated as the owner of the Foreign Bank shares under local law.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 46

contexts of nonfungible property (e.g., real estate and equipment) and fungible assets (e.g., publicly-traded securities). In the context of nonfungible assets, the case law (most of which relates to sale-leasebacks) generally concludes that a relative weighing of economic benefits and burdens determines tax ownership. As noted, the question has been reexamined in the context of ownership of publicly-traded assets where, under the securities loan authorities, the relative economic benefits and burdens are deemed to be all but irrelevant.

As in our prior discussion with respect to the appropriate tax treatment of the swap instrument, the following discussion concludes that, regardless of the categorization of the asset, the overriding prerequisites for tax ownership are possession of title and control. If the taxpayer has neither and both attributes are vested with one or more unrelated persons, the taxpayer is not the tax owner. Only when title or control is split between two or more taxpayers do relative economic benefits and burdens become relevant.

The primary authorities supporting the above conclusion are those dealing with securities loans and forward contracts. With respect to securities loans, a securities lender that does not possess either title or control over any specific security is not its tax owner, notwithstanding the lender's retention of substantially all of the benefits and burdens of ownership. The predominant importance of title and control over a specific security to determine its tax owner allows the lender to have virtually all of the economic benefits and burdens and the right to obtain title to and control over a generic security without being treated as the security's tax owner. With respect to forward contracts, a taxpayer that is not the titleholder and does not exercise control over an asset is not its tax owner, notwithstanding the taxpayer's ability to acquire title to and possession of a specific (unique) asset on a certain date, and the effective retention of substantially all of the asset's economic benefits and burdens during the term of the contract. Even though there is a certainty that the taxpayer will acquire title and control of the asset (assuming that the option is not cash-settled), before that time both reside in another party.

In the case of fungible assets (such as marketable securities), common law has effectively elevated dispositive power over benefits and burdens to determine tax ownership. The rationale behind this approach stems from the economic realities of fungibility, the significance of which may be illustrated by a simple example. A party that contracts to purchase Blackacre will generally be satisfied only if its counterparty

Investor
June 1, 1998
Page 47

delivers Blackacre. By contrast, a party that contracts to receive 100 shares of Foreign Bank common stock is indifferent, due to fungibility, as to which 100-share lot its counterparty delivers.⁷⁷

As noted, the conclusion that a taxpayer can transfer economic benefits and burdens to another party and yet maintain tax ownership is effectively validated by the recent enactment of Code Section 1259. The provision treats a taxpayer that holds securities and enters into an offsetting position as "constructively", not actually, selling the securities, and then as "constructively", not actually, repurchasing the securities. As discussed, prior to the enactment of Code Section 1259, the classic example of a transaction where the taxpayer was able to transfer the economic risks of holding a financial instrument while maintaining tax ownership was the short sale "against the box." In this transaction, the holder of an appreciated security borrows and sells an identical security, while retaining the one he already had. By holding two precisely offsetting positions, one short and the other long, the taxpayer was insulated from fluctuations in the security's value. The holder could then extract cash by borrowing up to 95 percent of the proceeds of the short sale from the broker.

In that a constructive sale under Code Section 1259 is not equivalent to the actual disposition of the appreciated position, it merely requires the taxpayer to recognize a gain, the new rules should not be inconsistent with Foreign LP's continued ownership of the Foreign Bank stock for U.S. federal income tax purposes.

b. Statutory Approach to Ownership

An alternative way of analyzing the tax ownership question is by analogy to the Code Section 901(k) minimum holding period requirement for obtaining a foreign tax credit for certain withholding taxes on dividends. In the Taxpayer Relief Act of 1997, the Code Section 243 dividends-received deduction ("DRD") holding period logic was applied in the context of entitlement to foreign tax credits. Before Taxpayer Relief Act of 1997, although prior law imposed a holding period requirement for dividends-received

⁷⁷ Fungibility is integral to the derivatives markets. Derivatives markets exist for publicly traded securities (or, for that matter, for oil, lumber, grain, or any other commodity) in large measure because fungible asset owners can "synthetically" replicate those assets with derivative contracts. Fungibility also allows derivative contract owners to "synthetically" replicate those derivative contracts using, among other things, the actual underlying commodity.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 48

deduction, there was no similar stock holding period requirement for claiming a foreign tax credit with respect to dividends. Consequently, it was possible for persons to engage in tax-motivated transactions designed to transfer foreign tax credits from those who could not benefit from the credit to those who could. In the Joint Committee on Taxation's General Explanation of Tax Legislation Enacted in 1997 ("Blue Book") it was noted that these tax-motivated transactions sometimes involved a short-term transfer of ownership of dividend-paying shares.

Code Section 901(k) denies a shareholder the foreign tax credits normally available with respect to a dividend for a corporation if the shareholder has not held the stock for a minimum period during which it is not protected from risk of loss. Under Code Section 901(k), the minimum holding period for dividends on common stock is 16 days, the pre-1984 Code Section 243 DRD holding period³⁴. Where the holding period requirement is not met, the foreign tax credits for the foreign withholding taxes are disallowed (however a deduction for the foreign taxes paid is allowed).

This arbitrary holding period of 16 days as a condition for allowing foreign tax credits with respect to withholding taxes indicates that Congress believes that after the expiration of 15 days a taxpayer will be considered a shareholder of a corporation. It is not unreasonable to conclude that shareholder status should be granted to a taxpayer that

³⁴ In extending the DRD holding period from 16 to 46 days, the primary targeted abuse that Congress was addressing was "dividend stripping" transactions. Using this strategy, corporations would undertake an investment strategy involving very short holding periods (but exceeding 15 days) for high-yielding stocks during which they would receive a quarterly dividend. Since the stock could be expected to decline in price by approximately the amount of the dividend, the corporate shareholder would end up with a short-term capital loss and dividend income subject to a DRD deduction (85 percent in 1984). The risks that the stock would decline in price could be reduced by writing in-the-money call options or by short sales of similar stocks. The typical "dividend stripping" transaction involved buying a stock shortly before the ex-dividend date and selling shortly thereafter. An active dividend-stripping program would typically involve 20 consecutive trades per year and would result in the generation of high after-tax rates of return. In 1958, Congress thought that it had sufficiently discouraged tax-motivated dividend stripping by applying a 16-day holding period requirement. In 1984, the conference committee opted to increase the 16-day holding period to 46 days, half the period between the typical quarterly ex-dividend dates. It was concluded that the longer holder period would increase the risks associated with a dividend-stripping strategy and reduce the number of such transactions that a taxpayer could do during a year from a maximum of 22 (365 divided by 16) to a maximum of 7 (365 divided by 46). Whereas it was observed that it was doubtful that these changes would completely eliminate dividend-stripping strategies, the changes would keep it within tolerable levels.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 49

satisfies this 16 day holding period in other contexts. It should be noted that although this analogy may be useful for this analysis, these rules do not deny ownership of the stock for U.S. federal income tax purposes, they merely eliminate the right of the shareholder to claim a foreign tax credit. Thus, the Code Section 901(k) rules have no effect on the taxpayer's holding period or ability to claim a gain or loss on disposition.

As to protection against risk of loss, any period during which the shareholder has protected itself from risk of loss (under the rules of Code Section 246(c)(4)) is disregarded. The example contained in the Blue Book assumes that a taxpayer buys common stock and the day after the stock is purchased the taxpayer enters into an equity swap under which the taxpayer is entitled to receive payments equal to the losses on the stock. Referencing Treas. Reg. Section 1.246-3(d)(2), it was concluded that the taxpayer had protected itself against risk of loss. Generally, Code Section 246(c)(4) provides that the holding period of stock, for purposes of the DRD, is reduced for periods where the taxpayer (1) has an option to sell, (2) is under a contractual obligation to sell, (3) has made (and not closed) a short sale, or (4) is the grantor of an option (other than a "qualified covered call option") to buy substantially identical stock or securities.

Treas. Reg. Section 1.246-5(c)(2) provides that an option to sell (a put) that is significantly out of the money does not diminish the taxpayer's risk of loss on its stock unless that option is held as part of a strategy to substantially offset changes in the fair market value of the stock. The put option purchased by Foreign LP has a strike price which is 10% out of the money. This would be the equivalent to being two benchmarks, or significantly out of the money as the term is used in Treas. Reg. Section 1.246-5(c)(2).²⁸ Generally, a "qualified covered call" is a listed option that is granted more than 30

²⁸ On May 27, 1993 the Treasury issued Prop. Reg. Section 1.246-5. In the preamble to Prop. Reg. Section 1.246-5, the Treasury indicated that whether a taxpayer has diminished its risk of loss on stock by holding an option depends on the degree of risk protection that option affords. Specifically, Prop. Reg. Section 1.246-5(b)(3) provides that "an option diminishes the taxpayer's risk of loss on its stock if decreases in the fair market value of the stock are expected to be offset substantially by increases in the fair market value of the option." Typically this will generally only occur when an option is in-the-money. Prop. Reg. Section 1.246-5 goes on to state that options to sell that are significantly out-of-the-money will not diminish the taxpayer's risk of loss on its stock.

On May 17, 1995, the Treasury finalized Treas. Reg. Section 1.246-5. The final regulations removed the language requiring "decreases in the fair market value of the stock are expected to be offset substantially by increases in the fair market value of the option". However, the final regulations maintained the language that "an option that is significantly out of the money does not diminish the taxpayer's risk of loss on its

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 50

days prior to its expiration and is not "deep-in-the-money". Generally, an option is not deep-in-the-money if its strike price is not less than the highest available strike price below the closing stock price on the day preceding the sale of the option.⁴⁰ See Code Section 1092(c)(4). The call options written by Foreign LP are initially written at a price which was 5% in the money. The price of the call option is equivalent to being one benchmark in the money, (i.e., not deep in the money).⁴¹ See Code Section 1092(c)(4)(C). Accordingly, Foreign LP should not diminish its risk of loss to the degree described in the regulations under Code Section 246.

As noted, Foreign LP held the Foreign Bank stock for more than 15 days. Furthermore, based on the put and call strike prices, Foreign LP did not diminish its risk of loss to the degree described in the Code Section 246 rules. As discussed in the previous section of this opinion, the courts and the Service have consistently held that

stock." Treas. Reg. Section 1.246-5(c)(3) did add one other caveat. Where an out-of-the-money option is held as part of a strategy to substantially offset changes in the fair market value of the stock, the Treasury can consider that option to reduce the taxpayer's risk. Although Treasury has indicated that each determination should be made on a case by case basis, courts have yet to interpret what would be considered under Treas. Reg. Section 1.246-5(c)(3) to be a strategy. However, guidance can be obtained from prior rulings and cases. The Service held in Rev. Rul. 80-238, 1980-2 C.B. 94, that where the taxpayer is not in a risk-free position, or where the element of risk is not greatly reduced or eliminated, the DRD holding period should not be reduced. This ruling, although issued prior to Treas. Reg. Section 1.246-5(c)(3), seems to capture the spirit of what Code Section 246(c)(4) is attempting to accomplish. Consequently, where the taxpayer is not in a risk-free position, or where the element of risk is not greatly reduced, the DRD should be available. Additionally, a risk-free position should be such that the taxpayer has guaranteed himself against risk of loss. For example, if the taxpayer were to write a call option and sell a put at the same strike price, the taxpayer would be protected against loss regardless of any movement in the stock price. Essentially, the call and put options would function as a synthetic short position and insulate the long position, much the same as a short-against-the-box transaction. (See *Proventive Corporation v. U.S.*, 970 F.2d 188, holding period reduced for purposes of DRD during the period that the taxpayer held forward conversions on shares of stock where dividends were paid.) However, where the taxpayer purchases an out-of-the-money option to sell, without writing a call option with the same strike price, a degree of risk exists such that the taxpayer can suffer loss and the holding period should not be reduced.

⁴⁰ For example, assume a stock is trading at \$48 per share and call options on the stock are trading with strike prices of \$30, \$35, \$40, \$45, \$50, and \$55. Because the qualified covered call exemption does not apply if the option's strike price is more than one benchmark below the stock's closing price, options with a strike price of \$30, \$35, and \$40 are deep-in-the-money and, therefore, are not qualified covered calls. Options with a strike price of \$45, \$50, and \$55 are eligible for exemption.

⁴¹ The same conclusion should apply to the "knock-in" options.

Investor
June 1, 1998
Page 51

diminishing risk of loss to the degree of the instant case is not inconsistent with ownership of the underlying security for U.S. federal income tax purposes. Therefore, based on the authorities discussed above, we are of the opinion that it is more likely than not that Foreign LP will be treated as the owner of the Foreign Bank shares for U.S. federal income tax purposes.

2. Application of the Step Transaction Doctrine.

a. General Overview of the Step transaction Doctrine.

An application of the step transaction doctrine could potentially impact the determination of whether a redemption results in capital gain treatment under Code Section 302(b) or dividend income under Code Section 301. For example, in the instant case if Investor's ultimate disposition of its portfolio position in Foreign Bank shares and options could be aggregated with the redemption transaction, there would be a complete termination of Foreign LP's interest in Foreign Bank stock.

In general, the step transaction doctrine has been used by the courts to determine whether the substance of a series of transactions undertaken by a taxpayer should prevail over the form of the transactions as constructed by a taxpayer. Application of the step transaction doctrine by the courts can be best described as amorphous. One of the more insightful observations that has been made in applying the doctrine was by Judge Easterbrook in *Sears Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992): "substance prevails over empty forms." As articulated by the Tax Court, the step transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result." See *Essex, Inc. v. Commissioner*, 90 T.C. 171, 195 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989).

The courts have traditionally applied three basic formulations of the doctrine. These are the "binding commitment", the "mutual independence", and the "end result" tests. See *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520, 524-525 (7th Cir. 1982); *Cal-Maine Foods, Inc. v. Commissioner*, 93 T.C. 181, 198-199 (1989); and *Perrod v. Commissioner*, 88 T.C. 1415, 1429 (1987).

The "binding commitment" test. The "binding commitment" test is the narrowest and most formalistic of the three versions of the step transaction doctrine. This approach integrates a series of transactions only if there is a binding legal commitment to undertake each of the steps. See Commissioner v. Gordon, 391 U.S. 83, 96 (1968). The "binding commitment" test is primarily directed at transactions where the transactions under consideration span several tax years and at the time the first transaction is undertaken, there is a binding commitment to undertake the subsequent transactions. See Commissioner v. Gordon, 391 U.S. 96; Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), *cert. denied* 450 U.S. 913 (1981), *rev'g* 71 T.C. 597 (1979); and King Enterprises, Inc. v. U.S., 418 F.2d 511, 518 (Cl. Ct. 1969).

The "end result" test. In contrast to the "binding commitment" test, which looks to formal commitment as evidence of taxpayer intent, the "end result" test integrates a series of steps into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be undertaken for the purpose of reaching an ultimate result. See King Enterprises, Inc. v. U.S., 418 F.2d at 516. The broadest in scope of the three approaches, the "end result test" focuses upon the subjective intent of the parties involved and whether, as revealed by the substance of the transaction, the ultimate result was intended from the outset. See King Enterprises, Inc. v. U.S., 418 F.2d at 518. Although where such intent has been present, courts have been disposed to combine purportedly separate steps and bind taxpayers to the tax consequences of an integrated transaction, they have generally been reluctant to recharacterize a transaction by inventing steps not actually taken by the taxpayer under scrutiny. See Esmark, Inc. v. Commissioner, 90 T.C. at 196.

The "mutual interdependence" test. The "mutual interdependence" test requires the integration of a series of transactions only if each is so interdependent on the others that the legal relationships created by each step is fruitless without the completion of the series. See American Bantam Car Company v. Commissioner, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). See also Redding v. Commissioner, 630 F.2d at 1177; Dvess v. Commissioner, 65 T.C.M. (CCH) at 2717 (1993) *aff'd*, 25 F.3d 1119 (5th Cir. 1994). This approach focuses not upon ultimate results but rather on the relationship between steps. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d at 524. Its application is appropriate in instances where it is "unlikely that that any one step would have been undertaken except in contemplation of the other integrating acts...." Kuper v.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 53

Commissioner, 533 F.2d 152, 156 (5th Cir. 1976). For example, where the taking of one purportedly separate step in a transaction has been contingent on completion of another, courts have been unwilling to accord the steps independent significance and have integrated them into a single transaction for tax purposes. See Associated Wholesale Grocers, Inc. v. U.S., 927 F.2d 1517 (10th Cir. 1991).

When such interlocking legal relationships are absent, however, courts have been reluctant to integrate multi-step transactions under the "mutual interdependence" approach. In Redding, for example, the taxpayer had received a distribution of transferable stock warrants from a corporation in which the taxpayer held common stock. The warrants entitled the taxpayer to purchase, for additional consideration, stock in the corporation's wholly-owned subsidiary. The taxpayer exercised all the warrants issued to him and purchased stock in the subsidiary. The Tax Court, in applying the step transaction doctrine, concluded that the warrant distribution and acquisition of subsidiary stock ought to be treated as a single transaction involving the distribution of the subsidiary's stock to the taxpayer. Having also concluded that the other necessary requirements of Code Section 355 had been met, the Tax Court held that the overall transaction qualified as a Code Section 355 spin-off and should therefore be tax-free to the taxpayer. Redding v. Commissioner, 71 T.C. at 597. On appeal by the Service, however, the Seventh Circuit, in reversing the Tax Court, refused to construe the warrant distribution and subsequent stock purchase as a single transaction under the "mutual interdependence" test. Redding v. Commissioner, 630 F.2d at 1178⁴².

b. Application of the Step Transaction Doctrine to Code Section 302

⁴² The Redding judgment was based on the fact that some of the shareholders of the corporation (including the taxpayers) was under any obligation to exercise the warrants distributed to them. In addition, the warrants were transferable to nonshareholders, and the underwriters involved had agreed to purchase (at a price somewhat reduced from the actual exercise price of the warrants themselves) any stock of the subsidiary not acquired by exercise of the warrants. Therefore, as the appeals courts pointed out, "the money would have come in and the stock gone out with or without the exercise of the warrants." Redding v. Commissioner, 630 F.2d at 1177. Noting that the primary objective of the warrant distribution was the raising of new capital, the court also decided that it had economic significance independent of any individual shareholder's decision to exercise and to actually acquire the subsidiary's stock. Hence, the necessary level of interdependence between the two steps was lacking, and the court found little evidence that the corporation had acted in concert with its shareholders to achieve the joint objective of a tax-free spin off of the subsidiary. Redding v. Commissioner, 630 F.2d at 1178.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 54

The seminal court case in the context of redemption transactions is *Zenz v. Quinnivan*, 213 F.2d 914 (6th Cir. 1954). The Zenz doctrine, which is named after the case, applies step transaction principles to evaluate the effects of related dispositions of stock to determine whether the standards of Section 302(b) have been met. It is important to note that the Zenz doctrine does not entail a conventional application of the step transaction doctrine in that the individual steps of an integrated transaction are respected, not collapsed. In applying the Zenz doctrine, the step transaction doctrine is used to evaluate the "relatedness" of individual steps so as to determine the points in time that are immediately before and after the redemption. Once this is determined, it is then possible to measure the resulting changes in ownership.

The Service has generally limited the application of the Zenz doctrine to integrated plans that are "firm and fixed" and which are carried out in a short period of time. See GCM 39290 (9/27/84). For example, in Revenue Ruling 75-447, 1975-2 C.B. 113, a redemption of T stock from two T shareholders was aggregated in Situation (1) with a new issuance of T stock and, in situation (2) with the sale of T stock by the two T shareholders, where in each case the second step followed immediately after the first step. See also Rev. Rul. 77-455, 1977-2 C.B. 93 and Rev. Rul. 81-186, 1981-2 C.B. 85. Under all three revenue rulings, the results are based upon the parties' intent under the end results test and a legal relationship analysis under the mutual interdependence test.

In *Zenz*, an individual (A) owned all the stock of T. Two other individuals (B and C), who owned a competing business, wished to acquire T's stock but not to inherit T's earnings and profits or related liquid assets. B and C purchased 50 percent of T's stock from A, and three weeks later, T redeemed the balance of A's stock in exchange for the liquid assets. A took the position that the redemption was taxable as a sale or exchange, not as a dividend, because it completely terminated A's interest in T. The Service argued, and the lower court agreed, that the redemption was taxable as a dividend, on the ground that the result should be the same as if the steps were reversed. The Sixth Circuit overturned the lower court's decision stating that it was satisfied that where the taxpayer effects a redemption that completely extinguishes the taxpayer's interest in the corporation, and does not retain any beneficial interest whatsoever, such transaction is not the equivalent of the distribution of a taxable dividend to him. In GCM 35216 (1/29/73), the Service stated that "as long as the sale and redemption are clearly parts of one overall plan, it makes no difference whether the sale precedes or follows the

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 55

redemption. As we read the Zenz opinion, the 6th Circuit...was not concerned with formal steps as such."

Although the acceptance of the Zenz doctrine by the Service is generally beneficial to individual taxpayers seeking capital gain treatment, the Service has also asserted its application in the context of corporate taxpayers seeking dividend income treatment. In Rev. Rul. 77-226, 1977-2 C.B. 90, the Service applied the Zenz doctrine to the detriment of a corporate shareholder. In the ruling, T had 300,000 shares of publicly traded common stock outstanding. On April 4, 1976, T offered to repurchase its shares for \$250 per share. On April 5, 1976, an unrelated corporation, P, purchased 4,000 T shares for \$1 million and immediately tendered 800 shares to T for \$200,000. On April 21, 1976, P sold the remaining 3,200 shares in the open market for \$800,000. P took the position that the redemption proceeds of \$200,000 were taxable as a dividend, subject to the dividends received deduction, and that its basis in the remaining 3,200 shares (\$800,000) was increased by its basis in the 800 redeemed shares (\$200,000). Consequently, the sale of the 3,200 shares resulted in a short-term capital loss of \$200,000. The Service, applying Zenz, held that the redemption and sale were undertaken pursuant to an integrated plan that completely terminated P's interest in T.

The Service did not explain the basis for its conclusion that P's actions were taken pursuant to an integrated plan. However, economic compulsion may have influenced the Service's position. T's self-tender offer effectively established the market price for T stock. This is evidenced by the fact that P paid \$250 per share to purchase T stock and received \$250 per share 16 days later when it sold T stock.

A significant number of court decisions and, to a lesser extent, rulings of the Service have implicitly employed the "end result" test in evaluating whether a series of transactions involving dispositions of stock by a shareholder qualify for sale or exchange treatment under Code Section 302. See GCM 39290 (9/27/84). The holdings of the court cases taking this approach have turned on whether the multi-step stock redemption (or combined stock redemption/sale) at issue was executed pursuant to a "firm and fixed plan." See Tiffany v. Commissioner, 16 T.C. 1443 (1951); Howell v. Commissioner, 26 T.C. 846 (1956); United States v. Carey, 289 F.2d 531 (8th Cir. 1961); Himmel v. Commissioner, 41 T.C. 62 (1963), *rev. g.*, 338 F.2d 815 (2d Cir. 1964); Leleux v. Commissioner, 54 T.C. 408 (1970); Niedermeyer v. Commissioner, 62 T.C. 280 (1974), *aff'd* 535 F.2d 500 (9th Cir. 1976), *cert. denied*, 429 U.S. 1000 (1976); Benjamin v.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 56

Commissioner, 66 T.C. 1084 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979); Bleily & Collihan v. Commissioner, 72 T.C. 751 (1979), *aff'd*, 647 F.2d 169 (9th Cir. 1981); Roehling v. Commissioner, 77 T.C. 30 (1981); Johnston v. Commissioner, 77 T.C. 679 (1981); Johnson v. Commissioner, 78 T.C. 564 (1982); Monson v. Commissioner, 79 T.C. 827 (1982); and Clark v. Commissioner, 86 T.C. 138 (1986), *aff'd*, 828 F.2d 221 (4th Cir. 1987).

Generally, although such a plan need not be reduced to writing, be absolutely binding on the parties, or communicated to others, the presence of such factors tends to show that a plan is "fixed and firm". See Niedermeyer v. Commissioner, 62 T.C. at 292. However, even a written, legally binding agreement will fail to be sustained as a "fixed and firm plan" if, at the behest of its principals, the specified steps are not faithfully adhered to and carried out. See Johnston v. Commissioner, 77 T.C. at 687-688. Of paramount importance is the question of intent and whether the objectives of the parties as contemplated in the plan are realized. At a minimum, there must be some evidence that the purported plan exists and that the parties (including the shareholder being redeemed) intended from the outset that it be carried out. *Id.* See also Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Rev. Rul. 55-745, 1955-2 C.B. 223; Rev. Rul. 75-447, 1975-2 C.B. 113; Rev. Rul. 77-226, 1977-2 C.B. 90; GCM 39290 at 12; and Monson v. Commissioner, 79 T.C. at 835-836. The failure of a plan to provide specifics as to when its respective steps are to be completed, particularly if execution of the steps spans multiple tax years, will undermine the contention that it was fixed and firm. See Benjamin v. Commissioner, 66 T.C. at 1114. See also Paparo v. Commissioner, 71 T.C. 692 (1979). Transactions in which a small number of individuals (e.g., one or two shareholders in a family corporation) may control and act with discretion with respect to both whether and when subsequent steps in a putative series of redemptions will occur invite particular scrutiny. See Roehling v. Commissioner, 77 T.C. at 55. Benjamin v. Commissioner, 66 T.C. at 1113-1115. In other words, not only must the intent behind a purported plan be "firm," but the conditions under which the plan is to be executed must be "fixed" as well. A redemption made by a closely-held corporation to accommodate the individual financial needs of a shareholder, for example, tends to undermine the contention that it was made pursuant to a "fixed" plan. Johnston v. Commissioner, 77 T.C. at 686.

Where evidence of a plan exists, there is demonstrable taxpayer intent, the plan is carried out as intended, and either the timing of the steps involved is laid out reasonably

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 57

precisely in advance or the steps occur within close temporal proximity of one another. courts have generally treated a multi-step redemption or redemption/sale transaction as an integrated plan. In such cases, the courts have accorded the taxpayer sale or exchange treatment (provided, of course, that the overall transaction meets one of the four substantive requirements of Code Section 302(b)).

For example, in Blitly & Collishaw, 72 T.C. at 751, the taxpayer corporation, a construction contractor, owned stock in a subcontractor with which it did business. When the taxpayer discontinued its construction business, the subcontractor sought to repurchase its stock owned by the taxpayer. The taxpayer offered to sell all the stock for a certain price. The subcontractor did not have sufficient cash, but it anticipated being able to purchase a portion of the taxpayer's stock each month. As funds became available, the subcontractor subsequently redeemed all of the taxpayer's stock over a seven-month period. The Tax Court held this arrangement constituted a firm and fixed plan to redeem all of the taxpayer's stock and accorded the taxpayer exchange treatment with respect to the transaction.

The Tax Court also found an integrated plan to exist in Roebbling. As part of a recapitalization, a bank decided to eliminate all of its preferred stock by redeeming a certain number of shares each year, subject to regulatory approval, and amended its certificate of incorporation to so provide. The taxpayer, the principal shareholder of the bank, offered to and did have a portion of her preferred shares redeemed each year to the extent that other preferred shareholders did not offer their shares for redemption. The Tax Court held that this arrangement was an integrated plan which resulted in a substantial reduction in the taxpayer's interest in the bank, and accorded the taxpayer exchange treatment. The Court noted that, while the number of shares redeemed each year over a twelve-year period varied, the plan was fixed in that each year's redemptions were subject to approval by the bank's regulators.

Where evidence of a plan, taxpayer intent, or taxpayer action consistent with intent is lacking, and either the timing of the steps involved is uncertain or the steps do not occur within close temporal proximity of one another, however (as in the cases of Benjamin, Himmel, Johnson, Johnston, Leleux, Niedermeyer, and Paparo), courts have refused to integrate a transaction's multiple steps and have subjected the taxpayer to dividend treatment.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 58

In Niedermeier v. Commissioner, 62 T.C. at 280, for example, the taxpayers owned all the preferred stock of a closely-held corporation, as well as some of its common stock. The taxpayers sold all their common stock to a corporation controlled by their sons in September 1966, and donated all of their preferred stock to a charity in December 1966. The taxpayers claimed these dispositions completely terminated their interest in the corporation and hence were collapsible into a single transaction that was eligible for exchange treatment. The Tax Court stated that, while a plan does not need to be in writing, absolutely binding, or communicated to others, such factors tend to show "a plan which is fixed and firm," and no such indicia were present in this case. Most importantly, the Tax Court found there was no pattern of charitable giving to indicate the taxpayers intended to make the December 1966 gift at the time they sold their common shares (although the taxpayers had made similar gifts in 1956, 1958, 1959, 1961, 1962 and 1963).

In Benjamin v. Commissioner, 66 T.C. at 1084, the Service challenged the claimed Code Section 302(b) treatment with respect to proceeds received by the taxpayer in 1964 upon the redemption of a portion of the preferred stock she held in a family corporation. Under the terms of a 1950 agreement, the taxpayer, the sole shareholder of the subject corporation's voting preferred stock, had previously committed to transferring all of the preferred shares she owned to her three sons (who held only nonvoting common stock of the corporation). From 1958 through 1966 (except for the years 1960 and 1964), the corporation annually redeemed 10 shares of the taxpayer's stock. In addition, the taxpayer donated stock to members of her family over roughly the same period. In defending her treatment of the 1964 redemption of 2,000 shares as a sale, the taxpayer sought to cast the transaction as part of plan (the 1950 agreement) to completely terminate her interest in the corporation.

When and how the eventual transfers of the preferred stock to the sons were to be accomplished had not been clearly specified in the agreement, however. Moreover, the agreement did not clearly require that the transfers be accomplished through a redemption or series of redemptions. At trial, the taxpayer could only assert that the agreement had called for a redemption or retirement of her stock "in the nebulous future." Her husband's recollection was only that, under the terms of the agreement, redemption of his wife's shares was to begin "as soon as possible." One of her sons interpreted the agreement to mean that redemptions of her interest were to begin "when the corporation was in a good financial position." Benjamin v. Commissioner, 66 T.C. at

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 59

1113-1114. In agreeing with the Service that the 1964 redemption was essentially equivalent to a dividend, the Tax Court highlighted the absence of any common understanding among the shareholders regarding the specific terms under which the taxpayer's preferred shares were to be redeemed, and the fact that the 1950 agreement itself was silent on the issue. Accordingly, the court held that the 1964 redemption was not made pursuant to a fixed and firm plan, despite the fact that the taxpayer's remaining preferred stock had been completely redeemed by the end of 1968.

Similarly, in Johanson v. Commissioner, 77 T.C. at 679, the redeemed taxpayer, her ex-husband, and her son all held shares in a family corporation. Under the terms of a 1973 agreement, the taxpayer was obligated, beginning in 1974, to offer 40 shares of the common stock she owned in the corporation for sale at book value to her ex-husband. In the event he declined to purchase the stock, she was required to offer the shares for sale to her son. If her son declined to purchase the shares, and if the ex-husband and son could not agree on some other individual to whom she could offer the shares for purchase, the corporation was required to redeem the shares at book value for cash.

During the years 1974 through 1979, the taxpayer offered her shares for purchase first to her ex-husband and then to her son, neither of whom agreed to purchase any shares. In 1976, 1977, and 1978, the corporation redeemed 40 shares pursuant to the agreement, but failed to do so in 1974 and 1975. The taxpayer evidently did not press the issue for 1974 and 1975 because she had sufficient income from other sources in those two years. The corporation encountered financial difficulties in 1979 and failed to redeem any shares that year, and the taxpayer, apparently deferring to the judgment of her son, in his capacity as president, that a distribution would harm the corporation financially, once again did not press her claim under the terms of the agreement. By 1980, the corporation's financial position had deteriorated to the point that, under the terms of the agreement, it was no longer required to make further redemptions.

The taxpayer claimed sale or exchange treatment with respect to the 1976 redemption, contending that it was part of plan, under the terms of the 1973 agreement, to terminate her entire interest in the corporation. The fact that the taxpayer enforced her right to have her stock redeemed in only 3 out of the 6 tax years in which it was enforceable, however, persuaded the Tax Court that the 1976 transaction should not be treated as part of a fixed and firm plan. The court was troubled not only by the degree of discretion exercised by the taxpayer over the timing of the redemptions called for in the

Investor
June 1, 1998
Page 60

agreement, but also by the fact that redemptions could be postponed upon the recommendations of corporate management, even though the corporation, under the terms of the agreement, was obligated to redeem the taxpayer's shares.

An application of the step transaction doctrine to the present situation would treat Foreign LP's redemption of its Foreign Bank stock and Investor's disposal of its Foreign Bank stock and options as components of a single transaction. Both dispositions would be viewed as occurring in tandem and Investor's Foreign Bank holdings would not be attributed to Foreign LP when determining whether Foreign LP had redeemed its Foreign Bank stock for purposes of Section 302(b). See Zenz v. Quinlivan, 213 F.2d at 914. Thus, Foreign LP's sale of its Foreign Bank stock back to Foreign Bank would qualify as an exchange under Section 302(b)(3). The resulting sale treatment would exhaust Foreign LP's basis in its Foreign Bank stock. Treas. Reg. Section 1.302-2(c) would not apply and there would be no allocation of basis to Investor's Foreign Bank shares.

Analysis of the facts under the "binding commitment" test. The foregoing discussion indicates that, although the presence or absence of a formal agreement to carry out the several steps in an integrated plan has been an important consideration in the judicial and Service application of the step transaction doctrine in the Code Section 302 context, it has been secondary to the issues of taxpayer intent, concrete evidence of the existence of a plan consistent with that intent, and whether the plan (and therefore the intent) was carried out. Therefore, the "binding commitment" test, standing alone, is probably not the most relevant application of the step transaction doctrine. Its theoretical relevance to the current transaction aside, we note that there was in fact no agreement, either written or oral, binding or contingent, committing Investor to any action with respect either to the Foreign Bank stock or the options it held following the redemption of Foreign LP's Foreign Bank shares. This being the case, we are of the opinion that it is more likely than not that the "binding commitment" test should not apply to the current transaction.

Application of the "mutual interdependence" test. This version of the step transaction doctrine would cause Investor's ultimate disposition of Foreign Bank stock and options to be considered as part of the same transaction as the redemption of Foreign LP's Foreign Bank shares. The "mutual interdependence" test would only apply if there was an underlying legal relationship connecting the redemption and subsequent

Investor
June 1, 1998
Page 61

disposition by Investor and each of those two steps was fruitless without the completion of the other.

As a threshold issue, we note that, as discussed above, the "end result test" version of the step transaction doctrine has generally been applied by the courts in analyzing Code Section 302 cases. The bulk of these cases has focused on the correspondence between a taxpayer's intent and the results of a series of stock redemptions (or combined redemption/sale transactions), as opposed to the degree of interdependence between the steps in a transaction. We should also reiterate, as discussed above with respect to the "binding commitment" test, that there was in fact no legal relationship between Foreign LP's investment in Foreign Bank and Investor's direct investment in Foreign Bank shares and options.

In conclusion, both the fact and the timing of Investor's disposition of its Foreign Bank shares were uncertain at the point at which Foreign LP's own Foreign Bank shares were redeemed. Given this uncertainty about whether, and if so, when the disposition would occur, it is difficult to ascribe to it a high level of interdependence with the redemption of Foreign LP's Foreign Bank shares. Accordingly, under the analytic criteria employed by the Seventh Circuit in Redding, 630 F.2d at 1169, and the generally accepted view of the "mutual interdependence" test that, for it to apply, separate steps must be contingent upon one another and each "fruitless" without the completion of the other, we are of the opinion that it is more likely than not that this version of the step transaction doctrine would not cause Investor's disposition of Foreign Bank stock and options to be considered as part of the same transaction as the redemption of Foreign LP's Foreign Bank shares.

Application of the "end result" test. In cases which have involved testing multi-step stock redemption and redemption/sale transactions for sale or exchange treatment under Code Section 302(b), application of the "end result" test has focused upon the issue of whether a "fixed and firm" plan existed to carry out the various steps of the transaction at issue. Accordingly, for the "end result" version of the step transaction doctrine to cause Investor's disposition of Foreign Bank stock and options to be considered as part of the same transaction as the redemption of Foreign LP's Foreign Bank shares, these steps would have to be treated as having been undertaken pursuant to a "firm and fixed" plan.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 62

As discussed above, prevailing case law has found a "firm and fixed" plan when: (1) there is evidence that a plan exists, (2) there is taxpayer intent, (3) the plan is carried out as intended and (4) either the timing of the steps involved is laid out in advance or the steps will not occur over a lengthy period of time. Investor invested in its Foreign Bank shares and options for the purpose of making a profit on the investment. Accordingly, Investor planned to dispose of its Foreign Bank shares and options when financially advantageous. Both the fact and timing of these dispositions were subject to market movements and, thus, market uncertainties. Thus, as noted with respect to the "mutual interdependence" test, there was uncertainty as to both whether and when Investor would ultimately dispose of its Foreign Bank shares and options.

Also, as with the control exerted by the taxpayer over the timing of the redemptions she received in Johnston, 77 T.C. at 679, the fact that Investor was able to exert an even greater degree of control over whether and when it disposed of its Foreign Bank shares and options militates against application of the "end result" test to the instant case. The redemption in the instant situation can be further distinguished from the cases cited above in which a fixed and firm plan was found in that two different taxpayers disposed of their stock in Foreign Bank in two separate and economically independent transactions. Finally, since none of the parties was actually bound to carry out any particular single step in the transaction, it is hard to see how any portion of the scenario, and, especially, the conditions under which Investor would dispose of its shares and options, was "firm and fixed." In other words, although the transactional facts scrutinized in this analysis may rise to the level of a plan, it does not appear to have been "firm and fixed" for purposes of applying the "end result" test in the Code Section 302 context. Accordingly, we are of the opinion that it is more likely than not that the Service would be unsuccessful in attempting to treat Investor's disposition of its Foreign Bank stock and options as part of a "firm and fixed" plan and therefore occurring in tandem with the redemption of Foreign LP's own Foreign Bank shares.

In summary, we are of the opinion that it is more likely than not that none of the three variants of the step transaction doctrine will apply to cause Foreign LP's redemption and Investor's disposition of its Foreign Bank shares and options to be treated as a single transaction for U.S. federal income tax purposes.

3. Application of the Agency Doctrine.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 63

Like the step transaction doctrine, the agency doctrine could potentially recast the transaction to alter its tax results by treating Foreign LP as Investor's agent in effecting the various transactions. Thus, Investor would be viewed as the true owner of the Foreign Bank stock owned by Foreign LP. At least two Supreme Court cases have considered whether an agency relationship existed that affected the tax results of transactions.

In Commissioner v. Bollinger, 485 U.S. 340 (1988), the taxpayer, individually and through several partnerships, was engaged in rental real estate development. State usury law limited the rate of interest that could be charged to noncorporate debtors, so the taxpayer, at the lenders' behest, formed a wholly-owned corporation to be the nominal borrower. The corporation held legal title to the developed projects pursuant to written agency agreements with the taxpayer, and the taxpayer and the partnerships held themselves out to the lenders as the principals. Moreover, the corporate agent had no assets, liabilities, employees, or bank accounts; it merely forwarded loan proceeds to the partnership on whose behalf it had obtained a loan. The partnerships actively managed the properties and reported the income and losses generated by the developments on their partnership tax returns.

The Supreme Court, applying the six-part National Carbide test, rejected the Service's contention that the corporation was the true owner of the real estate developments and held that the corporation was a bona fide agent of the taxpayer and the partnerships. More specifically, the Court found that the agency relationship was adequately established in this case because (1) it was set forth in a written agreement at the time each development was begun; (2) the corporation acted as agent and not as principal with respect to all the developments for all purposes; and (3) the corporation was held out as the agent and not the principal in all dealings with third parties with respect to all the developments.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the taxpayer was a savings and loan association which, in the early 1980's, had large unrealized losses from its portfolio of long-term, low-interest home mortgages. Due to regulatory constraints, the taxpayer could not sell the loans without running the risk that the resulting losses would force its regulator to close it. Instead, the taxpayer's regulator proposed that the taxpayer and other savings and loans trade participations in various mortgages in their loan portfolios with the idea that such trades would be treated as

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 64

recognition events for U.S. federal income tax purposes. The taxpayer therefore traded a package of participation interests in its loan portfolio for similar interests in portfolios of four other savings and loans.

The Service argued that such trades were not tax recognition events because, among other things, they had no economic effect. In other words, the Service appeared to argue that the taxpayer's partners in the trade were merely acting as its agents, with the result that the taxpayer retained de facto ownership in the interests. The Supreme Court rejected this argument and held that the trades did have economic effect because (1) there was no evidence that the parties had acted other than at arm's length and (2) the taxpayer had not retained de facto ownership. The Court reasoned that because the mortgages traded involved different mortgagors and different properties securing the mortgages, there was an exchange of legally distinct properties giving rise to a true economic event for tax purposes.

The indicia of a principal-agent relationship in the instant case are not compelling. You have represented that all parties acted independently. There were no written agency agreements and no party held itself out to third parties as an agent of the others. Furthermore, you have represented that the parties acted at arm's length. The transactions also had independent legal and economic significance, primarily due to the economic interests in Foreign LP of Limited Partner and General Partner. Accordingly, we are of the opinion that it is more likely than not that Foreign LP would not be treated as merely an agent for Investor with respect to these transactions.

4. Application of the Business Purpose/Economic Substance Doctrine.

In order for losses arising from investments in stock or other financial instruments to be deductible, the transaction or series of transactions that gave rise to such losses must have economic substance and a business purpose. A series of transactions will not be respected unless the transactions have economic substance separate and distinct from the economic benefit achieved solely by tax reduction.

Business purpose issues have arisen frequently in the context of sale-leaseback transactions. In Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978), the Supreme Court held that where there is a genuine multiple-party transaction with economic substance, which is compelled or encouraged by business or regulatory

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 65

realities; is imbued with tax independent considerations; and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

After Frank Lyon Co., the courts created a two-part test to determine whether a transaction should be disregarded as a sham with no business purpose. In order for a transaction to be disregarded, "the court must find that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and that the transaction has no economic substance because no possibility of profit exists." See Rice's Toyota World v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985), *aff'd* 81 T.C. 184 (1983).

Although the test set forth in Rice's Toyota World is a two-prong test, taxpayers typically have not been successful in merely showing that a transaction had some business purpose where the transaction lacked economic substance. Although the two-prong test has been used in a number of cases, more contemporary decisions acknowledge that the two prongs are just two of the factors that go into the overall business purpose analysis. For example, in Torres v. Commissioner, 88 T.C. 702 (1987), the Tax Court found that computer sale-leaseback transactions had economic substance and a valid business purpose. The court noted that a sale-leaseback transaction should only be disregarded for tax purposes "if it is determined that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists."

A recent court decision in this area is ACM Partnership v. Commissioner, 73 T.C.M. (CCH) 3189 (1997).⁴¹ ACM has certain parallels, and significant distinctions, to the instant case. In 1988, Colgate incurred a large capital gain on the sale of one of its subsidiaries. Colgate used the proceeds of the subsidiary sale to retire short-term debt and also issued newly established long-term debt in connection with a newly established ESOP. As a result of the debt issuance, Colgate believed that it had a disproportionately large level of long-term debt.

⁴¹ ACM was issued in a memorandum opinion which indicates that the court believed that the case merely involved the application of settled law to a new factual situation.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 66

Colgate concluded that by acquiring its own debt through a partnership, rather than by simply refinancing it directly, it could pick the most advantageous market timing to actually refinance the debt. In 1989, Merrill Lynch devised a contingent installment note sale transaction structured through a partnership that would generate tax losses to offset the gain generated on the subsidiary sale.

Consistent with its plan to manage its long-term debt position and to shelter the subsidiary capital gain, in October of 1989, affiliates of ABN Bank ("ABN"), Colgate and Merrill formed ACM Partnership. The ABN, Colgate and Merrill affiliates contributed \$169.3 million, \$35 million and \$600,000 to the partnership and received partnership interests of approximately 82.63%, 17.07% and .29%, respectively. Initially, the partnership placed its \$205 million into a bank account earning at 8.75%.

On November 3, 1989, the partnership purchased \$205 million of floating rate notes from Citicorp that had a yield of 8.78%. Three weeks later, in order to generate the cash needed to finance the purchase of Colgate long-term debt held by third parties, the partnership sold \$175 million of the Citicorp notes in a taxable installment sale transaction to the Bank of Tokyo and Banque Francaise du Commerce Exterieur. In the sale, the partnership received \$140 million in cash and LIBOR-based installment notes with a present value of \$35 million. Colgate argued that the interest rate sensitivity of the notes allowed the partnership to hedge the interest rate exposure that it had as a holder of the Colgate debt.

Colgate took the position that by the operation of the installment sale regulations, the partnership could only use \$29 million of its total \$175 million basis in the Citicorp notes to offset the \$140 million in cash proceeds. As a result, the partnership recognized \$111 million of taxable income in its first year. The income was allocated to the partners in accordance with their partnership percentages so that more than 80% was allocated to the ABN affiliate, which was not subject to U.S. tax and which paid no tax in its country of incorporation. Under the Code Section 453 basis rules, the nearly \$146 million in basis that was not available to offset the gain on the sale was reallocated to the LIBOR notes. The LIBOR notes thus became built-in loss assets with a value of \$35 million and a basis of \$146 million.

The Tax Court was asked to decide three issues: whether the transaction should be disregarded because it lacked economic substance; whether one of ACM's partners,

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 67

the ABN affiliate, was actually a lender rather than partner; and whether certain partnership allocations lacked substantial economic effect under Code Section 704(b). Because the court found for the Service on the first issue, it did not address the other two issues. In reaching its conclusion, the court discussed a number of major business purpose cases including, among others, Gregory v. Helvering, 293 U.S. 465 (1935); Knecht v. U.S., 364 U.S. 361 (1960); Frank Lyon Company v. U.S., 435 U.S. 561 (1978); and Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), *aff'd* 44 T.C. 284 (1965). The court focused particular attention on Goldstein and a major part of the court's ultimate conclusion is based upon the Goldstein analysis.

Goldstein involved a taxpayer's attempt to use a "T-bill roll" to shelter her Irish Sweepstakes winnings. The plan called for Mrs. Goldstein to borrow a total of \$945,000 from two banks with interest at approximately 4% and to invest in Treasury Bills yielding 1.5%. Mrs. Goldstein prepaid the interest on the loans in the first year. This prepayment, which she deducted as interest, sheltered much of the Sweepstakes winnings. Eventually, the T-bills were sold at a loss on Mrs. Goldstein's behalf and her notes were canceled. The Tax Court disallowed the deductions holding that the transactions were not real and held out no prospect for economic benefit other than tax losses. Citing Knecht, the Tax Court noted specifically that "if saving 1958 income taxes was the *only significant benefit* to be derived ... then the Knecht and Bridges cases require that the deductions for so-called prepaid interest must be denied." See Goldstein v. Commissioner, 44 T.C. at 299.

To determine whether any "significant benefit" did accrue to the taxpayer, the Tax Court analyzed the underlying economics of the investment and concluded that "to have realized anything substantial beyond recovering her said outlay, the Treasury notes would have had to be sold considerably in excess of par, notwithstanding that they bore interest of only 1.5%, and were to mature at par only a short time later ... [Thus, the taxpayer] could not reasonably have had any purpose or intention through the foregoing transactions to appreciably affect her beneficial interest except to reduce her taxes." See Goldstein v. Commissioner, 44 T.C. at 299, 300.

On appeal, the Second Circuit disagreed with the Tax Court in holding that the loans were sham. In this regard, the court noted that the Goldsteins had entered into the transactions with independent financial institutions, that the loans remained outstanding for six months rather than just a few days and that the notes were recourse. The Second

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 68

Circuit affirmed the Tax Court, nevertheless, because it found that the Goldsteins had entered into the loan transaction for the sole purpose of securing a large interest deduction. The court noted that "the interest deduction should be permitted whenever it can be said that taxpayer's desire to secure an interest deduction is *only one of mixed motives* that prompts the taxpayer to borrow funds there must be *some substance* to the loan arrangement beyond the taxpayer's desire to obtain tax benefit [emphasis added]." See Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir. 1966).

The Tax Court in ACM noted that other courts have applied the Goldstein principle including the Tax Court's controversial decision in Sheldon v. Commissioner, 94 T.C. 738 (1990). In Sheldon, a sharply divided court disallowed large tax benefits from a transaction that generated a relatively small economic profit. The Service then agreed to a settlement in the case so as to prevent appellate review. The point of controversy in Sheldon was the court's observation that the non-tax business purpose must be weighted against the tax purpose. The court noted the profits generated were infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions. Although the cases discussed above uniformly support the notion that a taxpayer must have some business purpose, none of the cases attempt to quantify the amount of business purpose necessary for a taxpayer to prevail. Sheldon merely notes that it cannot be infinitesimally small.

The Tax Court in ACM provided the following test for making this determination:

"The transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry."

The court then provided guidance concerning when a transaction is "rationally related" to the taxpayer's situation. According to ACM, a rational relationship will ordinarily not be found unless the taxpayer had a reasonable expectation that the nontax benefits of the transaction would at least equal the transaction costs. This conclusion effectively follows Goldstein, where the court held that it does not make economic sense to pay 4% for a chance to earn 1.5%.

Investor
June 1, 1998
Page 69

Based upon a detailed analysis, the Tax Court concluded that the relevant portions of the ACM transactions were economic shams which were devoid of any non-tax business purpose and which did not have a rational nexus to Colgate's stated purpose of liability management. In reaching this conclusion, the court effectively bifurcated the ACM transaction into those components that provided the claimed tax benefit and all other components of the transaction. Although the court found that Colgate had made an overall pre-tax profit on its ACM investment, even after taking into account transaction costs, the court also found that the pre-tax profit of the tax benefit components did not exceed their transaction costs.

The Tax Court found that at the time it entered into the partnership, Colgate's only real opportunity to earn a profit was through an increase in the credit quality of the issuers of the notes, or a 400-500 basis point increase in three month LIBOR interest rates. The Tax Court found no impact on credit quality was possible as the lenders were already highly rated at the time of the transaction. Moreover, the Tax Court did a six year review of three month LIBOR rates and did not find an increase of even 300 basis points in the necessary time frame. Since the analysis of the historical data showed no reasonable basis for expecting a profit, the Tax Court ruled against ACM.

Unlike ACM, in the instant case Investor had a profit motive upon entering into its portfolio transactions. The investment strategy that Investor entered into included a highly leveraged indirect investment (through the swap) in relatively volatile financial instruments, Foreign Bank common stock and options. Investor also made direct investments in Foreign Bank shares and options. This contrasts with the ACM transaction, which featured a non-leveraged investment in short-term, high-grade debt instruments that have minimal pricing volatility. Unlike ACM, Investor's contemporaneous analysis of the historical and statistical transaction models provided by Investment Advisor showed many instances where Investor could have earned a reasonable pre-tax profit in excess of fees and costs. Therefore, under the current state of the law, we are of the opinion that it is more likely than not that Investor should satisfy the requisite business purpose requirement since Investor had a reasonable expectation of making a reasonable pre-tax profit.

Although not consistent with the bulk of sham transaction cases, one case has indicated that there must be not only a reasonable chance of making a profit, but the

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 70

chance must relate to profit that is expected to be greater than de minimis. See Sheldon v. Commissioner, 94 T.C. 738 (1990). In the instant transaction, the expectation was that this standard would also be met. Again, Investor has represented that it believed that it had a reasonable opportunity to earn a reasonable pre-tax profit from the transactions described herein, in excess of all associated fees and costs and not including any tax benefits that may occur.

A potentially more difficult issue would arise if the motive to make a pre-tax profit must be greater than the tax benefit sought. Several courts have indicated that they would consider whether the profit motive was greater than the tax motive. See Fox v. Commissioner, 82 T.C. 1001 (1984) and Estate of Baron v. Commissioner, 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986). However, requiring that the profit motive be primary would be inconsistent with other areas of the tax law that have adopted a more generalized business purpose requirement either judicially (such as in reorganizations) or statutorily (such as Section 269).

Notwithstanding that the transactions in the instant case have the requisite economic substance, Code Section 165(c), where applicable, imposes additional limitations on the ability of individuals to claim the benefit of losses. If an individual incurs a loss from the disposition of the assets in the individual's trade or business, Code Section 165(c)(1) generally permits the allowance of such loss. In determining whether such a business exists, the courts have required that the criteria of Code Section 183 be met.

The determination of whether a transaction has been undertaken for profit for purposes of Code Section 183 is based on all the facts and circumstances. Treas. Reg. Section 1.183-2(b) lists nine specific factors that are to be taken into account in making this determination. The regulation also provides that "Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity... with the objective of making a profit." See Johnson v. U.S., 11 Cl. Ct. 17 (1986) which held that the taxpayer had a profit motive where the activity was engaged in with the objective of making, and a reasonable chance of making a reasonable pre-tax profit.

Like Code Section 183(a) and Treas. Reg. Section 1.183-1, Code Section 165(c)(2) and Treas. Reg. Section 1.165-1(e) require that individuals incurring a loss

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 71

from a transaction not involving a trade or business have a profit motive. Thus, these two statutes and regulatory provisions parallel each other. Notwithstanding the identical wording of the profit motive requirement in Code Sections 183 and 165, some courts have imposed a judicial gloss on Code Section 165(c)(2) (but not on Code Section 183(a)) that holds that the taxpayer's *primary* motive must be to generate pre-tax profits from the activity. See Fox v. Commissioner, 82 T.C. 1001 (1984).

The Tax Court based its expansion of the language of the statute on dictum found in Helvering v. National Grocery Co., 304 U.S. 282, 289 n.5 (1938), an accumulated earnings case. The Tax Court's reasoning in Fox seems questionable as there is little in the National Grocery decision to support the Tax Court's contention that the Supreme Court intended to change the meaning of Code Section 165(c)(2) in this way. The Court in Fox also based its decision on an earlier Code Section 165(c)(2) case, Smith v. Commissioner, 78 T.C. 350 (1982), *aff'd*, 820 F.2d 1220 (4th Cir. 1987). In Smith, however, the Tax Court did not impose the "primary" test articulated in Fox, but rather stated at page 391:

"The mere fact that petitioners may have had a strong tax avoidance motive in entering into their commodity tax straddles does not in itself result in a disallowance of petitioner's losses under Code Section 165(c)(2), provided petitioners also had a non-tax profit motive for their investments at the time. Knetsch v. United States, 348 F.2d 932 (Cl. Ct. 1965). Such hope of deriving an economic profit aside from the tax benefits need not be reasonable so long as it is bona fide. Bessenrey v. Commissioner, 45 T.C. 261 (1965), *aff'd*, 1379 F.2d 252 (3d. Cir. 1967)."

Both the Fox and Smith cases, as well as the bulk of subsequent cases involving the "primary" profit motive standard, arose in connection with commodities straddle transactions in which, looking at the transactions as a whole, the taxpayer had little or no opportunity to earn any meaningful profit. In addition, many of the decisions were memoranda decisions of the Tax Court. Neither the Knetsch case nor the Bessenrey case cited by the Tax Court in Smith required the profit motive of the taxpayer to be the primary standard for engaging in the transactions in issue, although the Knetsch decision did refer to the National Grocery Co. Supreme Court decision cited by Fox.

Investor
June 1, 1998
Page 72

Shortly after the *Fox* decision, another Tax Court decision used a different profit motive standard, *Estate of Baron v. Commissioner*, 83 T.C. 542 (1984), *aff'd* 798 F.2d 65 (2d Cir. 1986). In *Baron*, a master recording case, the Tax Court rejected the primary profit motive test and used an "intermediate" test in which it balanced profit against tax benefits. This test required a weighing "in the context of all the factors involved in determining the existence of the requisite profit objective, rather than applying a 'primary or dominant' test for non-tax factors ... or a sole objective test for the tax benefits." The Court of Claims subsequently offered yet another view of the profit motive test in *Johnson v. United States*, 11 Cl. Cl. 17 (1986). *Johnson* involved a wrap lease of computer equipment. It rejected the primary profit motive test and adopted a test based on the reasonable expectation of making a reasonable pre-tax profit.

As in the *Baron* and *Johnson* cases, the Court in *Nickson v. Commissioner*, 962 F.2d 973 (10th Cir. 1992) made a confusing attempt to deal with the primary standard. In *Nickson*, a case involving the application of Code Section 183(a), the court first appeared to apply the primary standard by requiring that the taxpayer engage in the transaction with the "dominant hope and intent to realizing a profit", but then went on to provide that "the determination crucial to the instant case (is) whether the taxpayers had an actual and honest profit objective." This confusion in part may be due to the fact that in *Fox*, which first applied the primary standard in the context of Code Section 165(c)(2), the taxpayers had little or no opportunity to make more than a token economic profit from the commodity straddles they entered into.

Much of the confusion that arises in this area results from misreadings of dicta and former court's findings. Originally the term "primarily" was a notion developed to determine how a mixed personal-profit transaction was to be characterized and not how a solely commercial transaction was to be treated. See *Austin v. Commissioner*, 298 F.2d 583 (2d Cir. 1962). As illustrated by the multitude of decided cases, no single, uniform standard exists for applying the primary test. This lack of uniformity can be attributed in part to the varying language and standards used by the courts to identify and apply the primary test. Additionally, the courts' failure to explicitly indicate the method used to compare a taxpayer's various objectives exacerbates the confusion surrounding the application of the primary test.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 73

Judge Swift of the U.S. Tax Court discussed the proposition that the primary test has not been developed uniformly by the courts in his concurring opinion in Pearl Oil & Gas Assocs. v. Commissioner, 100 T.C. 271 (1993). Judge Swift noted:

"The courts have not been consistent in the language used to describe the quantity or level of profit objective that must be established The inconsistent profit-objective language that has been used has included, among other language, the following: "Basic", "dominant", "primary", "predominant", "substantial", "reasonable", "bona fide", and "actual and honest". As one court commented, we have been "glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify."

For a further discussion of the lack of uniform language used by courts to describe the primary test, see Rose v. Commissioner, 88 T.C. 411-14 (1987) discussing different words used to describe the profit objective test; Johnson v. United States, 11 Cl. Ct. 17 (1986) discussing various profit objective tests applied by the Tax Court; Packard v. Commissioner, 85 T.C. 397 (1985) noting that courts have not clarified the quantity or degree of profit objective necessary for a transaction to be recognized for tax purposes.

We agree with the courts which conclude that the appropriate standard is a "reasonable expectation of a reasonable pre-tax profit". As discussed above, Investor had a reasonable expectation of a reasonable profit from its investments. Investor's profit motive is more like the facts of the Smith case than the Fox straddle case. Given Investor's reasonable expectation of making a reasonable profit compared to the taxpayer's in straddle cases like Fox and its progeny, we are of the opinion that it is more likely than not that Investor has the requisite profit motive to satisfy the requirements of Code Section 165(c)(2) and Code Section 183(a).

6. Applicability of Code Section 269.

Under Code Section 269, the Service has broad power to deny taxpayers the benefit of any deduction, credit, or other allowance when such benefit is secured through the acquisition, directly or indirectly, of control of a corporation. The Service must prove that the principal purpose of the acquisition was to evade or avoid federal income

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 74

tax by securing such benefit. An application of Code Section 269 could prevent Investor from acceding to Foreign LP's basis in its redeemed Foreign Bank stock if Investor acquired control of General Partner through exercise of the option in General Partner and such acquisition was made for the primary purpose of securing the benefit of an increased basis in its Foreign Bank stock.

The flush language of Code Section 269(a) states that "control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock of the corporation." Treas. Reg. Section 1.269-1(c) contains the same definition. Investor, however, did not own any stock of General Partner; it merely owned an option entitling it to purchase 50% of General Partner's stock. Although such option is deemed exercised for purposes of Code Section 302, there is no corresponding provision deeming its exercise for purposes of Code Section 269. Thus, because Investor elected to cash-settle its option to acquire General Partner stock, we are of the opinion that it is more likely than not that Investor will not acquire control of General Partner within the meaning of Code Section 269.

7. Applicability of Code Section 1059.

Code Section 1059 provides that corporate shareholders must reduce the basis of stock they hold in other corporations by the "nontaxed portion" of any "extraordinary dividends" paid thereon.⁴⁴ The nontaxed portion is the excess of the total amount of such dividend over the "taxable portion." The taxable portion is the portion of such dividend includible in gross income, reduced by the amount of any dividends received deduction of Code Sections 243, 244, and 245. Accordingly, if the redemption of Foreign LP's Foreign Bank shares is considered to be a distribution to Foreign LP that is an extraordinary dividend under Code Section 1059, there is a risk that Investor might not be able to increase the basis of its own Foreign Bank shares by the amount of Foreign LP's basis in its redeemed Foreign Bank shares. However, Code Section 1059 will not apply if the extraordinary dividend received by Foreign LP does not qualify for the

⁴⁴ Under Code Section 1059(a)(1), the payee does not reduce basis below zero. However, the payee must recognize gain on a subsequent disposition of stock upon which an extraordinary dividend has been paid to the extent this limitation prevents reduction of basis. Code Section 1059(a)(2).

Investor
June 1, 1998
Page 75

dividends received deduction, unless the dividend is not otherwise included in the gross income of Foreign LP.

Code Section 1059 is only applicable to "extraordinary" dividends. Extraordinary dividends are defined at Code Section 1059(c). In general, the definition is applicable where a dividend exceeds a "threshold" percentage described by Code Section 1059(c)(2). In addition, Code Section 1059(e)(1) provides that a dividend will be "extraordinary", notwithstanding the threshold percentage test, if it is made as a redemption which is either a partial liquidation per Code Section 302(e), a non-pro rata distribution, or caused to be characterized as a dividend by operation of Code Section 318(a)(4).⁴⁵ Foreign Bank's distribution to Foreign LP would be an extraordinary dividend under either Code Section 1059(c) or 1059(e)(1).

As noted, Code Section 1059 requires a basis reduction equal to the "nontaxed portion" of the extraordinary dividend. Per Code Section 1059(b), the nontaxed portion of an extraordinary dividend is:

Total dividend
Less: "taxable" portion of dividend
"Nontaxed portion" of dividend

Per Code Section 1059(b)(2), the "taxable" portion of the dividend is:

Amount includible in "gross income"
Less: dividends received deduction
"Taxable" portion of dividend

The first step in the analysis outlined above is to determine the amount includible in "gross income." In general, the determination of gross income is made by reference to Code Section 61. Code Section 61 states that, "*except as otherwise provided in this subtitle, gross income means all income from whatever source derived...*" (italics added).

⁴⁵ As amended by Taxpayer Relief Act of 1997, Code Section 1059(e)(1)(A)(iii) now provides that a redemption will be treated as an extraordinary dividend if it is characterized as a dividend and such dividend treatment was caused by the option attribution rule under Code Section 318(a)(4). The amendments made by TRA 1997 to Code Section 1059 apply to distributions made after May 3, 1995. [Since this is 1998, why isn't this amendment already incorporated into the text.]

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 76

This would include dividend income from any source as well as most other types of income. However, in the case of foreign corporations, other narrower definitions of gross income are provided elsewhere in Subtitle A of the Internal Revenue Code.

Under Code Section 882(b), "In the case of a foreign corporation, *except where the context clearly indicates otherwise*, (italics added) gross income includes only (1) gross income from U.S. sources that is not effectively connected with a U.S. trade or business, and (2) gross income that is effectively connected with the conduct of a U.S. trade or business." Thus for each foreign corporation it is necessary to consider whether the general rule of Code Section 882(b) is applicable or, alternatively, whether the *context* where the term gross income is used clearly indicates that another definition should be used. At a minimum, however, the wording of Code Section 882(b) makes it clear that the concept of gross income may be expanded or modified for certain foreign persons.

The question of when and how the context of a tax statute will indicate the way gross income should be defined is not always clear. The language italicized above was first proposed as part of the 1986 Technical Corrections Act and subsequently enacted by the Technical Corrections Act of 1988. Unfortunately, neither regulations nor the legislative history under the Act is helpful in clarifying the extent to which the definition of gross income is broadened for foreign corporations.

Although there is little authoritative guidance on this question, the context question can arguably be addressed in several ways. One possibility is to ask how gross income should be defined in the context of a foreign corporation that has received an extraordinary dividend from another foreign corporation. A second possibility is to look at the concept of gross income as it applies to certain types of foreign corporations including "controlled foreign corporations" ("CFC"), "passive foreign investment companies" ("PFIC"), and "foreign personal holding companies" ("FPHC").

Turning first to Code Section 1059, the Code Section itself contains no indication of the way the gross income of a foreign corporation should be defined or calculated. The section seems to have been drafted with only the Code Section 61 definition of gross income in mind. Although final regulations that expand the scope of the definition of an extraordinary dividend were issued on June 16, 1997, these regulations have no bearing on the gross income concept.

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 77

Unlike the Code and regulations, the legislative history of Code Section 1059 is very helpful in clarifying why this section was added to the law. By inference, this information can be used to understand how gross income should be defined in the context of Code Section 1059. Code Section 1059 was enacted as part of the Tax Reform Act of 1984. The legislative history is comprised of Committee Reports (see H.R. Rep. No. 98-861, 98th Cong., 2d Sess. at 800 (1984), ("House Committee Report") and the "Blue Book" (See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, H.R. 4170, 98th Cong., 2d Sess. at 136 (1984).

The Blue Book in particular spells out that Code Section 1059 was enacted specifically to stop a transaction called "dividend stripping". As described in the Blue Book, in a dividend strip, a corporate taxpayer purchases stock prior to the ex-dividend date for an impending dividend, collects the dividend, and sells the stock as soon as it has been held for the period sufficient to earn a dividends received deduction. Generally the price of the underlying stock will have declined by the amount of the dividend, so the sale produces a capital loss. Such loss is used to offset other capital gains so that the outcome is a conversion of fully taxable capital gains into ordinary income taxed at a low effective rate due to the availability of the DRD.

In the 1984 Act, Congress attacked this transaction in several ways. The DRD holding period was lengthened to 46 days, the DRD holding period was suspended where the taxpayer eliminated his economic risk by certain types of hedging, and Code Section 1059 eliminated the opportunity for a capital loss immediately following the receipt of the dividend.

Based on the 1984 Blue Book and Committee Reports, it is clear that Code Section 1059 was enacted only to stop dividend stripping by domestic corporations who could take advantage of the DRD. There is nothing in the legislative history to indicate that it was ever intended to reach situations other than domestic dividend payments that qualify for the DRD. Therefore Code Section 1059's context, including its legislative history, strongly suggest that foreign corporations that could not qualify for a DRD were not intended to be subject to Code Section 1059. This is also significant evidence that, in the context of Code Section 1059, the use of the term "gross income", as applied to foreign corporations, should not be defined as a tax trap for those foreign corporations.

Further evidence that Congress could not have intended to apply Code Section 1059 to foreign corporations receiving foreign source income is provided by some of the absurd results that would follow. For example, if a CFC received a dividend from another foreign corporation that was Subpart F income to its U.S. shareholder, Code Section 1059 would appear to subject the U.S. shareholder to double taxation by reducing the CFC's tax basis in the dividend paying shares. Other examples can be found in the foreign tax credit area and the PFIC rules. An alternative approach to the context question is to look at the way the term gross income is used in the CFC, PFIC, and PFIC rules. As described below, the context of each of these sections clearly supports defining gross income differently than Code Section 882(b).

As discussed, controlled foreign corporations are not directly subject to U.S. federal income tax. Rather, Code Section 951 generally provides that certain "U.S. shareholders" of a CFC are subject to U.S. tax through a deemed dividend mechanism on their ratable share of the CFC's Subpart F income. Nevertheless, a determination of the CFC's gross income is required in determining the CFC's Subpart F income. For example, Code Section 954(c)(1) provides, "For purposes of subsection (a)(1), the term 'foreign personal holding company income' means the portion of the *gross income* which consists of: dividends etc..." (italics added). Thus, it would appear that the CFC rules are a place "where the context clearly indicates" that gross income should include categories of income such as foreign source dividends.

Similar to CFCs, PFICs are not generally subject to direct U.S. federal income taxation on their foreign source income. Also like CFCs, a determination of the PFIC's gross income is required for several purposes. Code Section 1297(a)(1) provides that "the term 'passive foreign investment company' means any foreign corporation if 75 percent or more of the *gross income* of such corporation for the taxable year is passive income..." (italics added.) In addition, Code Section 1297(b)(1) provides that the term "passive income" is defined by reference to the definition of foreign personal holding company income quoted immediately above. The language used in the PFIC rules indicates that PFICs are another instance where a broader definition of gross income that includes foreign source dividends is appropriate.

The foreign personal holding company rules are a third case where an expansive definition of gross income is required. For example, an PFIC is defined in Code Section

Investor
June 1, 1998
Page 79

552(a) as such by reference to a 60 percent gross income test. Furthermore, for purposes of the FPHC rules, "gross income" is defined by Code Section 553(a) as follows:

"For purposes of this part, the term "gross income" means, with respect to a foreign corporation, gross income is computed ... *as if the foreign corporation were a domestic corporation which is a personal holding company.*" (italics added)

The personal holding company rules in turn refer to "gross income" at Code Section 543(b)(1) and Treas. Reg. Section 1.542-2. Treas. Reg. Section 1.542-2 provides that: "For the definition of "gross income" see Code Section 61 and Treas. Reg. Sections 1.61-1 through 1.61-14." Thus, by specific reference, the FPHC rules incorporate a Code Section 61 broad definition of gross income to test a FPHC's status as an FPHC and to measure its FPHC income. This is perhaps the clearest case where the more restrictive Code Section 882(b) definition should not be applicable because the context, and specific wording of the sections, indicate otherwise. While it is not clear that a FPHC that receives an extraordinary dividend should define gross income in a Code Section 1059 calculation by reference to the FPHC definition of the term, such a result is supported by definitions found in the FPHC sections. Furthermore, the alternative would be to use the Code Section 882(b) definition and produce a result that Congress never intended.

On balance, we believe that the better view is that Code Section 1059 does not apply to a foreign corporation not otherwise directly subject to U.S. income tax. Based upon this logic, we are of the opinion that it is more likely than not that Code Section 1059 will not cause a reduction in the basis of the Foreign Bank stock.

8. Applicability of Code Section 1091.

Under Code Section 1091, taxpayers are precluded from claiming a loss from the sale of stock or securities if they acquire the same or substantially identical stock or securities during the period beginning 30 days before, and ending 30 days after, the date on which the loss transaction occurred. Code Section 1091(a) provides that the term stock or securities includes options. Any loss disallowed under these rules is not permanently foregone; instead, it is reflected in the basis of any newly acquired stock or securities. See Code Section 1091(d).

Investor
June 1, 1998
Page 80

In the instant case, Investor acquired Foreign Bank options on [date] and sold at a loss [number] Foreign Bank shares on [date]. In that the Foreign Bank stock was sold more than 30 days after Investor had acquired its Foreign Bank options, the loss disallowance rule under Code Section 1091(a) should not apply to the disposition of the Foreign Bank shares. Furthermore, the sale of the [number] options should not be subject to the wash sale rules since Investor did not purchase substantially similar stock or securities within the prohibited 61 day period with respect to such options. Accordingly, the provisions contained under Code Section 1091 would not affect our opinion that it is more likely than not that Investor would be attributed Foreign LP's basis in its redeemed Foreign Bank shares.

9. Applicability of Code Section 465 "At Risk" Rules.

In the case of an individual and certain "C" corporations, any loss for the taxable year from an activity to which Code Section 465 applies is allowed only to the extent of the aggregate amount with respect to which the taxpayer is "at risk" for such activity at the close of the taxable year. See Code Section 465(a). A corporation is subject to Code Section 465 if more than 50% of its stock (by value) is held by 5 or fewer individuals at any time during the last half of the taxable year. See Code Section 542(a)(2). The "at risk" rules apply to trusts and estates as well. See S. Rep. No. 94-938, 94th Cong., 2d Sess. 48 (1976), 1976-3 C.B. at 86 (the "Senate Report"); see also Code Section 641(b) (the taxable income of an estate or trust is computed in the same manner as an individual).

More than 50% of the outstanding stock (by value) of Foreign LP, a "C" corporation for U.S. federal income tax purposes, is held by 5 or fewer individuals at any time during the last half of the taxable year during which it holds the Bank stock. Consequently, the "at risk" rules of Code Section 465 apply to Foreign LP. Because Investor is an individual, Code Section 465 also applies to Investor.

a. Activities Subject to the Code Section 465 rules

Among the activities to which Code Section 465 applies is each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income. See Code Section 465(c)(3). These activities are aggregated or treated as separate activities

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 81

as the Treasury Department prescribes by regulations. No such regulations have been proposed or adopted.

Foreign LP engages in its activity with respect to it Foreign Bank stock investments for the production of income. Thus, an "at risk" activity of Foreign LP includes its investment in Foreign Bank stock. Similarly, an "at risk" activity of Investor includes its investment in Foreign Bank stock and Foreign Bank stock options because such investments are made for the production of income. Other activities of Investor may or may not be aggregated with Investor's investment in Foreign Bank stock and options.

b. The Amount "At Risk"

For purposes of Code Section 465, a taxpayer is considered "at risk" for an activity with respect to amounts including the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and the amount borrowed for use in an activity to the extent that the taxpayer is personally liable for repayment of such amount or has pledged property, other than property used in the activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property). See Code Sections 465(b)(1) and (2). A taxpayer is not considered "at risk", however, with respect to amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements. See Code Section 465(b)(4).

An amount borrowed is not "at risk" with respect to an activity if the amount is borrowed from any person who has an interest in the activity (other than an interest as a creditor in the activity) or from a related person to a person (other than the taxpayer) having such an interest. See Code Section 465(b)(3). This rule applies with respect to any activity engaged in by the taxpayer in carrying on a trade or business or for the production of income only to the extent provided in regulations. See Code Section 465(c)(3)(D); Alexander v. Commissioner, 95 T.C. 467, *rev'g on motion for reconsideration*, TC Memo 1990-141. No such regulations have been proposed or issued.

Code Section 465(b)(5) provides that if in any taxable year the taxpayer has a loss from an activity to which Code Section 465 applies, the amount with respect to which a

Investor
June 1, 1998
Page 82

taxpayer is considered to be "at risk" (within the meaning of Code Section 465(b)) in subsequent taxable years with respect to that activity is reduced by that portion of the loss which (after the application of Code Section 465(a)) is allowable as a deduction. Code Section 465 does not provide other adjustments relating to subsequent events with respect to an activity. Nonetheless other rules for adjusting a taxpayer's at-risk amount with respect to subsequent events include:

- A taxpayer's amount "at risk" is increased by the amount of taxable and tax-exempt income generated from the activity;
- A taxpayer's "at risk" amount is decreased as the taxpayer withdraws money or property from the activity, and
- A taxpayer's amount "at risk" may increase when liabilities associated with the activity are repaid.

See Prop. Treas. Reg. Sections 1.465-22, 1.465-23, and 1.465-66. See also Lansburgh v. Commissioner, 92 T.C. 448 (1989), (taxpayer's "at risk" amount increased to extent the taxpayer recognizes income with respect to the activity) and Allen v. Commissioner, 55 T.C.M. (CCH) at 688 (1988), (gain recognized on the disposition of the activity or an interest in the activity increases the taxpayer's amount "at risk"). These adjustments reflect that the "at risk" amount is determined in a manner consistent with the determination of the taxpayer's adjusted basis, except that certain nonrecourse debt amounts and amounts protected against loss are not included. See the Senate Report at 50.

The Code Section 465 proposed regulations also provide limited guidance regarding the effect of carryover and substituted basis transactions. For example, in certain circumstances where (a) a taxpayer transfers or disposes of its entire interest in the activity; (b) the basis of the transferee is determined in whole or in part by reference to the basis of the transferor; and (c) the transferor has an amount "at risk" which is in excess of losses from the activity, the transferor's amount "at risk" in the activity is added to the transferee's amount "at risk". See Prop. Treas. Reg. Section 1.465-68. There is no statutory basis for this type adjustment to the "at risk" amount of the taxpayer or its transferee. In such cases, however, the Treasury Department proposes to adjust the

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 84

Investor's activity that includes its investment in Foreign Bank stock and options may be aggregated with other activities of Investor for Code Section 465 purposes. At a minimum, however, the initial "at risk" amount Investor has in the activity that includes the investment in Foreign Bank stock and options should reflect the amount of money paid by Investor to acquire the Foreign Bank stock and options. In addition, based on the analysis above, it is more likely than not that Investor's "at risk" amount is increased with respect to such activity in an amount equal to the amount by which its adjusted basis with respect to such activity is increased under Treas. Reg. Section 1.302-3(c) as a result of the redemption of Foreign LP's Foreign Bank stock.

V. Applicability of Code Section 6662

Code Section 6662 provides for a 20% underpayment penalty for taxpayers if there is a substantial understatement of income tax on a return. For non-corporate taxpayers, an understatement is considered substantial for this purpose if it exceeds the greater of 10% of the correct tax or \$5,000. See Code Section 6662(d)(1).

An understatement does not include deficiency amounts attributable to a position which is either supported by "substantial authority"⁴⁶ or if there is a "reasonable basis" for the position taken and the relevant facts affecting the tax treatment are adequately disclosed. If the position involves a tax shelter⁴⁷, there must be both "substantial authority" for the position and the taxpayer must have "reasonably believed that the tax position was more likely than not the proper treatment". The "reasonable belief" requirement can be satisfied if the taxpayer reasonably relies in good faith (i.e., the taxpayer discloses all the facts it knows or should know) on the opinion of a qualified tax

⁴⁶ There is considered to be substantial authority for a return position if substantial authority is present either on the last day of the taxable period covered by the taxpayer's return, or on the date the return is filed. Regulation § 1.6662-4(g)(1)(ii)(A) and § 1.6662-4(d)(3)(iv)(C). This rule applies in all contexts i.e., regardless of whether the transaction is a "tax shelter," and regardless of whether the taxpayer is a corporation.

⁴⁷ Prior to the Taxpayer Relief Act of 1997, a tax shelter was generally defined as any plan or arrangement the principal purpose of which was the avoidance or evasion of U.S. federal income tax. Tax avoidance or evasion was considered the principal purpose if that purpose exceeded any other purpose. The 1997 Tax Act modified the definition of tax shelter by requiring only a "significant" (rather than principal) tax avoidance or evasion purpose.

Investor
June 1, 1998
Page 83

taxpayer's "at risk" amount with respect to subsequent events so that it tracks the taxpayer's and transferee's adjusted basis.

A specific parallel rule does not exist in Code Section 465, its legislative history, or regulations promulgated thereunder, for each conceivable adjustment to the basis of a taxpayer's property. In the absence of such Code Section 465 rule, the Treasury Department and the courts have determined appropriate "at risk" amount adjustments based on the principles governing correlative tax basis adjustments, except that basis adjustments relating to nonrecourse liabilities and amounts protected against loss are not taken into account. See *Lansburgh* and *Allen*, *supra*; see also Prop. Treas. Reg. Sections 1.465-22 and 1.465-68.

In the context of the basis adjustments governed by Treas. Reg. Section 1.302-2(c), no rule exists that addresses whether a taxpayer's "at risk" amount (attributable to an activity that includes an investment in stock that is redeemed) shifts to a related person upon the redemption of the taxpayer's stock. Treas. Reg. Section 1.302-2(c) adjusts the basis of related party stock to preserve tax basis that would be otherwise lost without the adjustment. If the "at risk" amount of the related person is not adjusted by a like amount, the purpose for the tax basis adjustment would go unfulfilled because as such tax basis is utilized by the related person it would be subject to a Code Section 465 limitation. In addition, no Code Section 465 policy is advanced by denying the "at risk" amount adjustment to the related person. In similar circumstances, the Treasury Department has determined that it is appropriate to transfer the "at risk" amount from the taxpayer to another person. See Prop. Treas. Reg. Section 1.465-68. Based on these considerations, it is more likely than not that the "at risk" amount of a person related to the taxpayer is increased by an amount equal to the tax basis adjustment realized by the related person pursuant to Treas. Reg. Section 1.302-2(c).

Foreign LP's initial "at risk" amount with respect to its activity that includes the investment in Foreign Bank stock includes the recourse loan amount which Foreign LP borrowed to acquire the Foreign Bank stock. Foreign LP's "at risk" amount should be adjusted for subsequent events related to its investment in Foreign Bank stock, including an increase equal to the net income realized by Foreign LP upon Foreign Bank's redemption of Foreign LP's Foreign Bank stock. See Prop. Treas. Reg. Section 1.465-66; see also *Allen v. Commissioner*, *supra*.

Investor
June 1, 1998
Page 85

professional that unambiguously states there is a greater than 50 percent likelihood that the tax treatment will be upheld if challenged by the Service.

Substantial authority for a position exists if the weight of authorities supporting the position is substantial in relation to the weight of authorities against the position. See Treas. Reg. Section 1.6662-4(d). Authorities for this purpose include (but are not limited to) applicable provisions of the Code; proposed, temporary and final regulations; revenue rulings and revenue procedures; court cases; Congressional intent as reflected in committee reports; private letter rulings and technical advice memoranda issued after October 31, 1976; and actions on decision and general counsel memoranda issued after March 12, 1981. The weight of an authority depends upon its relevance and persuasiveness, and the type of document. See Treas. Reg. Section 1.6662-4(d)(3).

The "substantial authority" standard is higher than the "reasonable basis" standard but generally below "more likely than not". See Treas. Reg. Section 1.6662-4(d)(2). As noted, the "more likely than not" standard is one where there is a greater than 50 percent likelihood that a position will be upheld if challenged by the Service. The "reasonable basis" standard has not been defined by regulation, but the Internal Revenue Manual ("IRM") states that the standard is one where a position is arguable but fairly unlikely to prevail in court. The Internal Revenue Manual further states that "the substantial authority exception can be met when the taxpayer has less than a 50 percent, but more than a one-in-three likelihood of being sustained on the issue." See IRM (20)535 (1997).

In addition to the ability to mitigate penalties through Code Section 6662(d)(2)(B), Code Section 6664(c) provides a general exception to Code Section 6662 penalties in the case of a position taken *with reasonable cause and in good faith* (the "reasonable cause exception"). Whether a taxpayer has "reasonable cause" and "good faith" is a facts and circumstances determination made on a case-by-case basis. The most important factor is the extent of the taxpayer's effort to assess proper tax liability. See Treas. Reg. Section 1.6664-4(b). Reliance on the opinion of a professional tax advisor constitutes "reasonable cause" and "good faith" if the advice is based on all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, relevant facts include the taxpayer's purpose for entering into a transaction and for structuring the transaction in a particular manner. All facts that

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 86

are relevant to the tax treatment of a transaction must be disclosed. See Treas. Reg. Section 1.6664-4(c).

The regulations also set forth certain general opinion requirements ("General Opinion Requirements") that must be satisfied in order for reliance on tax advice, including opinion letters, to be considered reasonable and in good faith. Treas. Reg. Section 1.6664-4(c)(1). The General Opinion Requirements (all of which must be satisfied) are as follows:

- The opinion was based on all pertinent facts and circumstances, including the taxpayer's purposes (and the relative weight of such purposes) for entering into the transaction and for structuring the transaction in a particular manner. In addition, reliance on an opinion will not be considered reasonable if the taxpayer fails to disclose a fact that it knows or should know to be relevant to the proper tax treatment of an item.
- The opinion was based on the law as it relates to those facts and circumstances.
- The opinion was not based on any unreasonable factual or legal assumptions (including assumptions as to future events).
- The opinion did not unreasonably rely upon the representations, statements, findings or agreements of the taxpayer or any other person. For example, the opinion must not be based upon a representation or assumption that the taxpayer knows or has reason to know is unlikely to be true.

Although we have located no court case that has construed the General Opinion Requirements (which were issued in August of 1995; see T.D. 8617), numerous judicial decisions have relied upon similar principles in holding that a taxpayer's reliance upon the advice of a tax professional qualified for the reasonable cause and good faith exception to the substantial understatement penalty. See, e.g., *Mauger v. Commissioner*, 22 F.3d 1001 (10th Cir. 1994) (the substantial understatement penalty was not imposed where a physician reasonably relied in good faith upon his independent tax advisors); *Vorscheck v. Commissioner*, 933 F.2d 757 (9th Cir. 1991) (the taxpayers' reliance on their tax accountants precluded imposition of the substantial understatement penalty); *Hensley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990) (the taxpayers' efforts to assess their proper tax liability by consulting an accountant and their limited

Investor
June 1, 1998
Page 87

experience in tax matters precluded the application of the substantial understatement penalty: Dagost v. Commissioner, 67 T.C.M. (CCH) 2914 (1994) (the negligence and substantial understatement penalties were not imposed where the taxpayers reasonably relied upon professional advisors); and English v. Commissioner, 65 T.C.M. (CCH) 2160 (1993) (the negligence and substantial understatement penalties were not imposed where the taxpayers relied upon the advice of their accountants on a complex tax matter).

The U.S. Supreme Court also reaffirmed the right of a taxpayer to rely upon the substantive advice of the taxpayer's accountant or attorney to avoid penalties in United States v. Boyle, 469 U.S. 241 (1985) (which distinguished between reasonable reliance on professionals to avoid filing deadlines, which did not constitute "reasonable cause," and reasonable reliance on professionals as to questions of substantive law, which would). According to Boyle:

"When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place." *Id.* at p. 251.

Conclusion

Based on and subject to the facts, documentation, representations and assumptions described herein and our discussion and analysis of the relevant statutory provisions and judicial doctrines, we are of the opinion that under current U.S. federal income tax law there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the following positions will be upheld if challenged by the Internal Revenue Service:

- Foreign LP and General Partner will be classified as corporations for U.S. federal income tax purposes with respect to the transactions analyzed herein;

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 88

- The amount paid to Foreign LP by Foreign Bank in redemption of the Foreign Bank shares owned by Foreign LP will be treated as a dividend under Code Sections 301 and 316;
- Foreign LP's tax basis in the redeemed Foreign Bank shares will be attributed and allocated to Investor's separately purchased Foreign Bank shares pursuant to Treas. Reg. Section 1.302-2(c) (and potentially to Investor's Foreign Bank options under Treas. Reg. Section 1.61-6);
- Investor will not be subject to U.S. taxation with respect to the amount treated as a dividend to Foreign LP on the redemption on its Foreign Bank stock under the Subpart F, foreign personal holding company or passive foreign investment company rules;
- Payments made by Investor to Limited Partner under the swap contract will not be subject to U.S. withholding tax.

Our conclusions are based on the completeness and accuracy of the above-stated facts, representations and assumptions. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions.

This opinion is not binding upon any tax authority (e.g., the Internal Revenue Service) or any court and no assurance can be given that a position contrary to that expressed in this letter will not be asserted by a tax authority and ultimately sustained by a court. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, and the judicial and administrative interpretations thereof, which are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless you specifically request otherwise, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

Very truly yours,

Proprietary Material
Confidentiality Requested

KPMG 0035790

3337

KPMG DRAFT: 6/1/98

Investor
June 1, 1998
Page 89

KPMG Peat Marwick LLP

RSB:rsb

Proprietary Material
Confidentiality Requested

KPMG 0035791



PRIVATE & CONFIDENTIAL

Dear ,

The purpose of this letter is to define the role of KPMG Peat Marwick LLP ("KPMG") in the proposed participation of [name of investor] ("Client") in an investment strategy (the "Strategy") and to confirm our understanding of the terms of our engagement to assist Client as a tax advisor in connection with Client's participation in the Strategy. For purposes of this letter, references to "Client" shall be deemed to include the owners of Client (the "Owners"), and such Owners shall be deemed individual parties hereto for all undertakings and agreements of Client contained herein. The Owners of Client (or their authorized representative) shall execute this letter in their individual capacity, as well as their capacity as officers, directors, or employees of Client. The background for your participation in the Strategy and the role of KPMG are as follows.

Background

1. KPMG understands that Client intends to engage Presidio, a registered investment advisor, to provide Client with investment advisory services and trading strategies designed to permit Client to acquire both directly, and indirectly, a position in the shares of a foreign financial institution to be selected by Client from alternative investee financial institutions offered by Presidio.
2. KPMG understands that Presidio will facilitate the purchase of shares and options in a foreign financial institution. The purchase of the foreign financial institution shares and options will involve full economic risk to Client in the stock market movement (up or down) of the foreign financial institution securities. Client may realize either profits or losses based upon the movement of the foreign financial institution shares. No one has provided Client or the Owners with any assurances or guarantees that they will make money in any of these transactions. Client and Owners are at all times subject to market risks for both reward and loss. We recommend that Client and Owners seek independent advice concerning the investment aspects of the proposed transactions. Client and Owners acknowledge that they understand that they must have a reasonable expectation of achieving a reasonable profit from the Strategy (separate and apart from any tax benefits realized).

Proprietary Material
Confidentiality Requested

KPMG 0035792

Page 2
February 9, 2002

and that Client and Owners have received such investment advice concerning the Strategy, if from Presidio and/or other qualified investment advisors).

3. Client intends to enter into a total return swap agreement with respect to an offshore investment company in connection with the Strategy.

KPMG's Role as Tax Advisor.

KPMG has agreed to provide Client with tax consultation services concerning the U.S. federal income tax consequences of the various transactions that may be undertaken with respect to the Strategy. KPMG agrees that, upon the request of Client, we will provide Client with a tax opinion letter. Client and Owners acknowledge that any tax opinion issued by KPMG would not guarantee tax results, but would provide that the tax treatment described in the opinion is "more likely than not" to occur. If such opinion is requested, it will be dependent on appropriate facts and representations of Client and the Owners.

Any tax opinion issued by KPMG in connection with the Strategy is to be used solely by Client for the purpose of evaluating the U.S. federal tax consequences of the Strategy, and is not to be used or relied upon by any other party or distributed to any other party.

Client acknowledges that KPMG has communicated that there are certain information reporting requirements imposed by the Internal Revenue Code of 1986 that might be considered applicable to Client's participation in the Strategy.

Our professional fees are based on the complexity of our role and on the value of the services that we provide, rather than directly on the hours we spend. We will bill you a fee of a minimum of \$_____ in consideration of tax consultation services provided in connection with the Strategy. During the latter part of the engagement, we will agree with you an additional amount for our services. The amount of our fee is not dependent on the amount of Client's investment in the Strategy, the investment results of the Strategy, the tax opinion expressed, nor on the amount of any tax savings projected or achieved by Client or Owners.

Liability

By approving this arrangement, Client and Owners, jointly and severally agree to

Proprietary Material
Confidentiality Requested

KPMG 0035793

indemnify KPMG and its affiliates, partners, principals, directors, officers, employees, agents and controlling persons (collectively, the "Indemnified Parties") from and against all losses, claims, damages, and liabilities, including reasonable attorney's fees and other expenses or costs of litigation (collectively, "Damages"), to which the Indemnified Parties may become subject under any applicable federal or state law or other statutes, common law, or otherwise, and arising, directly or indirectly, from this engagement as the result of any assertion by Client or an Owner or any family member or creditor of an Owner of Client. The Indemnified Parties shall not be indemnified to the extent such Damages directly and immediately result from KPMG's bad faith or gross negligence. In the event any Indemnified Party is requested pursuant to subpoena or other legal process to produce documents relating to this engagement in judicial or administrative proceedings to which such Indemnified Party is not a party, you shall reimburse the Indemnified Party at standard billing rates for the Indemnified Party's professional time and expenses, including reasonable attorney's fees, incurred in responding to such requests.

KPMG's aggregate maximum liability to Client and Owners arising for any reason relating to KPMG's performance of services hereunder, except to the extent determined to have resulted from the intentional or deliberate misconduct of KPMG personnel, shall be limited to fifty thousand dollars (\$50,000.00).

KPMG shall have no liability to Client, or Owners, for any special, incidental or consequential damages, including without limitation loss of profits, even if KPMG has been advised of the possibility of such damages.

Client and Owners will not directly or indirectly refer to KPMG or any of its affiliates in any printed, audiovisual, on-line or other advertising or promotional material prepared or distributed by or for you without KPMG's specific advance review and prior written approval. The provisions of this paragraph shall survive the expiration of this Agreement.

In the event that any term or provision of this Agreement shall be held to be invalid, void, or unenforceable, then the remainder of this Agreement shall not be affected, impaired or invalidated, and each such term and provision of this Agreement shall be valid and enforceable to the fullest extent permitted by law.

Please indicate your agreement to the above terms and understandings by signing the

Page 4
February 9, 2002

enclosed copy of this agreement and returning it to us.

Sincerely,
KPMG Peat Marwick LLP

Partner
Enclosure

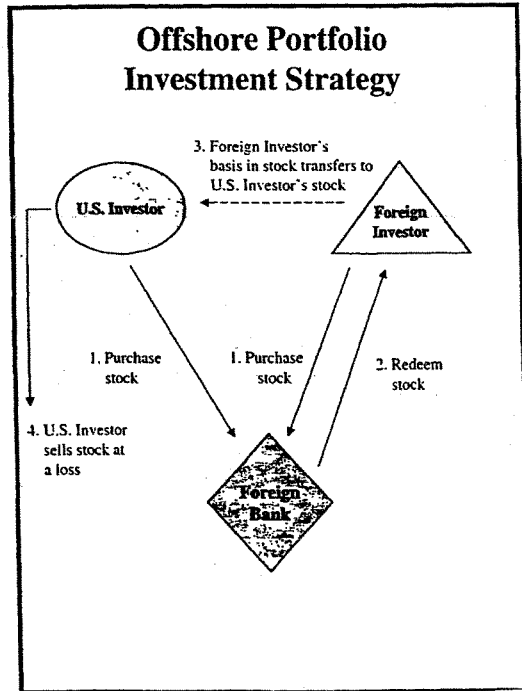
ACCEPTED:

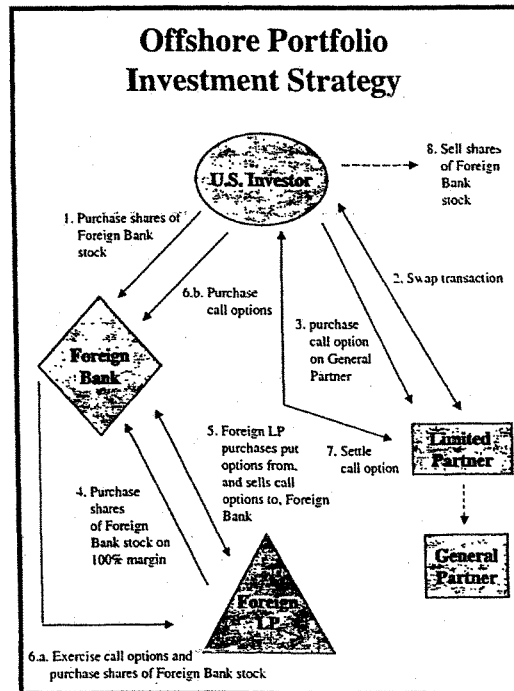
Client

Name: _____
Title: _____ Date: _____
Owner (or Authorized Representative)

Name: _____
Title: _____ Date: _____

**Offshore Portfolio
Investment Strategy
(OPIS)**





Offshore Portfolio Investment Strategy

- Description of OPIS:
 - A highly leveraged investment strategy whereby a U.S. investor invests directly and indirectly in the stock of a foreign bank.
 - The investment strategy requires participation by five parties -- a U.S. Investor (USI), a foreign limited partnership (FLP) owned by a foreign individual (FI) and a foreign corporation (FC), and a foreign bank (FB) -- and involves the following steps:
 - Investor purchases shares of stock in FB.
 - Investor enters into a swap transaction with a FI whereby Investor pays FI an up-front fee and FI agrees to pay Investor an amount equal to 90% of any distributions on FI's FLP interest and 90% of the appreciation thereon during swap term.
 - Investor purchases a call option from FI to acquire 90% of FI's interest in FC.
 - FLP purchases shares of FB on 100% margin.
 - FLP purchases put options from FB on 100% of its FB stock.
 - FLP sells call options to FB on 90% of its FB stock.
 - FB exercises its call options and purchases FB shares from FLP.
 - Investor purchases call options from FB equal to the number of shares FB redeems from FLP.
 - Investor sells call options back to FLP or lets them expire.
 - Investor sells shares of FB stock.

Offshore Portfolio Investment Strategy (cont.)

- Benefits of OPIS:
 - Enables U.S. investor to maximize leverage in stock of a foreign bank and thereby potentially increase investment return.
 - Maximizes U.S. investor's basis in foreign bank stock and thereby minimizes gain, or maximizes loss, on the disposition of such stock.



NONDISCLOSURE AGREEMENT

THIS NONDISCLOSURE AGREEMENT is made by and between *client*, an individual, and other parties noted below (hereinafter, "Counterparties"), and KPMG Peat Marwick LLP, a limited liability partnership ("KPMG") effective as of _____, 199_. The parties hereby agree as follows:

1. **Initiative Defined.** Counterparties may receive from KPMG information of a non-public nature for use by Counterparties and their partners, agents, employees and representatives in the course of Counterparties' evaluation of a proprietary structure (hereinafter, the "Initiative"), involving _____. Third-party financial and legal advisers (collectively "Representatives") may also receive the information (as defined below) relative to the Initiative provided Counterparties receive KPMG's written consent to such disclosure prior to providing the information to such Representatives.

2. **Information Defined.** The Counterparties acknowledge that, in the course of their discussions with KPMG in connection with the Initiative, Counterparties will receive certain private and proprietary information about the Initiative, including, but not limited to, technical, financial or business information and models, names of partners or participants, proposed structures, documentation of the Initiative (including, without limitation, memoranda, opinions, diagrams and presentations) or any other private and proprietary information relating to the Initiative which may include certain trade secrets (hereinafter, "Information"). Any information supplied by KPMG to Counterparties prior to the execution of this Agreement shall be subject to the same treatment as the information made available after the execution of this Agreement.

3. **Exclusions from Definition.** The term "Information" as used herein does not include any data or information that: (i) is already known to Counterparties at the time it is disclosed to Counterparties; or (ii) before being divulged by Counterparties; (iii) has become generally known to the public through no wrongful act of Counterparties or their Representatives; (iv) has been rightfully received by Counterparties from a third party without restriction on disclosure and without a breach of an obligation of confidentiality running directly or indirectly to KPMG; (v) has been approved for release by a written authorization by KPMG; or (vi) is independently developed by Counterparties without use, directly or indirectly, of the information received from KPMG.

4. **Nondisclosure Obligation.** Counterparties shall keep the information confidential and shall not disclose such information, in whole or in part, to any person or entity in connection with Counterparties' evaluation of, or participation in, the Initiative except with the prior written consent of KPMG or as otherwise permitted hereunder. Furthermore, Counterparties shall not disclose the information to their Representatives without KPMG's prior written consent. Such Representatives shall be informed by _____

Counterparties of the confidential nature of the Information and Counterparties shall cause such Representatives to agree in writing to be bound by this Agreement. The Information shall be used by Counterparties solely for the purpose of evaluation of or participation in the Initiative, and the Counterparties agree that Counterparties shall not arrange, enter into or otherwise be involved in any transaction that incorporates all or any significant element of the Information without receiving KPMG's permission and without compensation to KPMG in accordance with our standard fee with respect to the Initiative.

5. Compliance with Legal Process. In the event that the Counterparties are legally required to disclose any Information, Counterparties shall use their best efforts to promptly notify KPMG of such request or requirement prior to disclosure so that KPMG may seek an appropriate protective order and/or waive compliance with the terms of this Agreement.

6. Ownership; Return of Information. All Information (including tangible copies and computerized or electronic versions and summaries thereof) shall remain the property of KPMG. Within ten (10) days following the receipt of a written request from KPMG, Counterparties shall deliver to KPMG all tangible materials containing or embodying the Information received from KPMG, together with a certificate executed by Counterparties certifying that all such materials in Counterparties' possession or control have been delivered to KPMG or destroyed. Counterparties shall not assert directly or indirectly any right with respect to the Information which impair or be adverse to KPMG's ownership thereof.

7. Remedies for Breach. Counterparties understand and agree that money damages may not be a sufficient remedy for any breach of this Agreement and that KPMG shall be entitled to seek injunctive or other equitable relief to remedy or forestall any such breach or threatened breach. Such remedy shall not be deemed to be the exclusive remedy for any breach of this Agreement, but shall be in addition to all other rights and remedies available at law or in equity.

8. No Representations or Further Obligations. None of the Information which may be disclosed by KPMG shall constitute any representation, warranty, assurance, guarantee or inducement by KPMG to Counterparties of any kind.

9. Term; Termination. Either party may terminate the exchange of Information under this Agreement at any time by written notice to the other specifically referencing this Agreement. In any event, however, the obligations of Counterparties to maintain the confidentiality of the Information it has received under this Agreement and the restriction on Counterparties' use of such Information shall continue for a period of three (3) years from the date hereof.

10. No Waiver. No failure or delay by KPMG in exercising any right, power or privilege hereunder shall operate as a waiver thereof, nor shall any single or partial

exercise thereof preclude any other or further exercise thereof or the exercise of any other right, power or privilege hereunder.

11. Amendment. This Agreement may not be modified, supplemented or amended orally, but only by a writing signed by both parties hereto.

12. Governing Law. This Agreement shall be governed by and construed and enforced in accordance with the laws of the State of New York, without regard to its choice of law provisions.

13. Attorney's Fees. Should any party to or beneficiary of this Agreement find it necessary to employ legal counsel and bring an action at law or in equity to enforce any of the terms or conditions of this Agreement caused by the breach or default of the other party, the non-prevailing party in any such proceeding shall reimburse the prevailing party for all reasonable attorneys' fees and costs incurred pursuing such proceeding.

IN WITNESS THEREOF, the parties have executed and delivered this Nondisclosure Agreement effective as of the date first written above.

Counterparties:

KPMG Pear Marwick LLP:

Name:

By: _____
Name:

Name:

Name:



new

From: Jeffrey A. Elschold
Sent: Tuesday, September 01, 1998 8:23 AM
To: "Mark, Bob" [SMTP:MARKPAFF@PRESIDIOADV.COM]; "Larson, John"
[SMTP:LARSON@PRESIDIOADV.COM]
Cc: Larry DeLap
Subject: OPIS

I just spoke with Larry DeLap about our concerns relating to KPMG engagement letters for the OPIS transactions. I have assured Larry that Presidio will not execute trades on behalf of KPMG clients without the affirmative assurance from me that an approved engagement letter is in place.

Please let me know if this is a problem.

Jeff

Tax Innovation Center Overview

det
4/7/01

Tax Innovation Center Mission

KPMG's **Tax Innovation Center (TIC)**, part of Washington National Tax (WNT), serves as the central resource group supporting tax solution and tax service idea development initiatives of the firm's tax functional groups. Dedicated management and staff, under the supervision of the **Partner in Charge – Tax Solution Development (PIC – TSD)**, and the **TIC Leadership Team**, work directly with the firm's tax solution groups (Federal Tax (including Compensation & Benefits, Stratcon, Exotax, Mergers & Acquisitions, Tax Controversy Services, and Tax Management Services), Personal Financial Planning, State and Local Tax, International Executive Services, and International Services), industry groups, Tax Knowledge Management, marketing and communications, the **Department of Professional Practice (DPP) – Tax**, **Department of Professional Practice (DPP) – Assurance**, and other national and firm resources to enhance cross-fertilization of solution/service opportunities, raise all tax solution group development activities to a consistent standard and process, and assist in the delivery of integrated, high-value tax solutions and services. New or enhanced tax solutions generally are announced firmwide through a **Tax Solution Alert (TSA)** and frequently are accompanied by a comprehensive set of support materials.

Formatted: Font: Bold
Deleted: Tax Innovation Center (TIC)
Deleted: Partner in Charge – Tax Solution Development (PIC – TSD)
Formatted: Font: Bold
Formatted: Font: Bold
Deleted: TIC Leadership Team
Deleted: the
Formatted: Font: Bold
Deleted: Department of Professional Practice (DPP) – Tax
Formatted: Font: Bold
Deleted: Department of Professional Practice (DPP) – Assurance
Formatted: Font: Bold
Deleted: Tax Solution Alert (TSA)

Tax Innovation Center Professionals

Tax Solution development is one of the four priority activities of WNT (the other three are Technical Leadership, Tax Knowledge Management, and support of the National Accounts program). As such, a significant percentage of WNT resources are dedicated to Tax Solution development at any given time. Specifically, select individuals are dedicated to Tax Solution development on a full-time basis (i.e., spend 75 percent or more of their time in that activity), while all other WNT professionals spend on average 25 percent of their time on Tax Solution development activities. *This operating model involves all WNT professionals in Tax Solution development, with approximately 40 to 50 percent of the full-time equivalent resources of WNT dedicated to Tax Solution development.*

Formatted: Font: Bold
Deleted: Tax Solution

Dedication of full-time Tax Solution development resources in the **Tax Innovation Center (TIC)** occurs along the lines of the functional and solution groups within WNT (e.g., Accounting Methods, Passthroughs, SALT, and PFP), principally at the senior manager/manager and tax associate levels. Select individual partners also focus full-time on solution development. *With the exception of the TIC Leadership Team, most full-time solution development resources are also full-time members of their respective WNT functional solution groups. (A limited number of TIC professionals support the development of general federal tax solutions and services and, therefore, are not formally connected to a WNT solution group.)*

Formatted: Font: Bold
Deleted: Tax Innovation Center (TIC)
Formatted: Font: Bold, Italic
Deleted: TIC Leadership Team

Day-to-day management of the solution development process and all full-time solution development resources is the responsibility of the **Partner in Charge – Tax Solution**

Formatted: Font: Bold

Tax Innovation Center
Solution Development Process Manual

i

Tax Innovation Center Overview

Development (PIC – TSD). Currently, the PIC-TSD is assisted by a full-time partner, three full-time senior managers, two full-time managers, and short-term staff rotationals. These professionals, two full-time marketing professionals, and three full-time Administrative Assistants constitute the TIC Leadership Team. Regular meetings of the TIC Leadership Team and select full-time solution development managers (collectively, the Solution Development Team) are held to ensure close coordination of all TIC activities.

~~Deleted: Partner in Charge – Tax Solution Development (PIC – TSD)~~

~~Formatted: Font: Bold~~

~~Deleted: Solution Development Team~~

TIC Solution Development Process

1. Collect and Screen Ideas

Ideas that are candidates for the **TIC Solution Development Process** originate from a number of places - consulting calls from operating office professionals to Washington National Tax technical resources, direct submissions of ideas to the **Tax Innovation Center (TIC)**, and **Tax Labs** have all led to ideas that have been considered for development into tax solutions. The purpose of this phase of the TIC Solution Development Process is to centrally collect ideas, screen the collected ideas for both technical viability and revenue potential, and prioritize the order in which ideas are addressed. Collectively, all screening and prioritizing activity can be thought of as tax lab activities.

a. Labs

Tax Labs are structured meetings of six or more tax professionals of a functional or solution group (e.g., SALT, CAB, Federal Tax, etc.) with the purpose of generating new ideas that may be entered into the **TIC Solution Development Process**. All Tax Labs must be approved by the WNT functional group and service line leader (in collaboration with Rick Rosenthal and Mike Lippman), as well as the **TIC Leadership Team**, under a screen that emphasizes innovation, speed, and the most effective use of resources (e.g., it is expected that most, if not all existing/new Tax Labs will meet no more often than bi-monthly). Mark Springer, current **Partner in Charge – Tax Solution Development (PIC – TSD)** and Richard Smith, PIC-WNT Operations, will have joint responsibility for developing and implementing the screening process on an ongoing basis. Each Tax Lab is jointly “owned” by a service line “sponsor,” generally a partner, and a WNT partner. Both the sponsor and WNT resource are accountable for the results of the lab.

Industry-focused labs will be jointly owned by the respective **Tax Industry Leader** and TIC Leadership Team. It is expected that industry labs will meet no more often than quarterly, and that participation in the labs will include a cross section of industry, service line, and functional tax expertise depending on the nature of the industry issues to be discussed at a particular lab meeting. With rare exceptions, it is not expected that specific service lines will hold industry labs. It is anticipated that Stratecon, International, and SALT will be represented at substantially all industry lab meetings. Participation by other service lines will be determined collaboratively by the Tax Industry Leaders and service line leaders, based on their assessment of market opportunities.

The **TIC Manager** from the particular functional or solution group should make plans for the Tax Lab at least two weeks prior to the Tax Lab date. The TIC Manager will send a message to the **Tax Lab Participants** seeking agenda items for the Tax Lab. The TIC Manager and the **Tax**

Lab Leader should discuss items to be included on the Tax Lab agenda. Once Tax Lab agenda items are finalized, the TIC Manager will forward the final agenda to the Tax Lab Participants.

The TIC Manager will notify the **TIC Administrative Assistant** of the date, time, and place for the Tax Lab and any special items that may be needed for the Tax Lab (e.g., Proxima, easels, pads, overheads). The TIC Administrative Assistant makes the particular meeting arrangements (e.g., space, food, special needs, etc.) and notifies the Tax Lab Participants of the final arrangements.

During the Tax Lab, the Tax Lab Leader facilitates the discussion of ideas listed on the Tax Lab agenda among the Tax Lab Participants. Ideas should be reviewed for initial tax technical viability. Other business issues related to the ideas should also be discussed. Finally, a determination is made of whether the idea should be entered into the TIC Solution Development Process. A designated Tax Lab Participant will be responsible for taking notes during the Tax Lab, drafting a **Tax Lab Summary**, and distributing the summary to the Tax Lab Participants within one week after the Tax Lab. Additionally, the Tax Lab Summary is to be reported to Rick Rosenthal, Mike Lippman, David Brockway, Richard Smith, and the respective service line leader.

The overall effectiveness of each lab (not each lab meeting) will be measured on a quarterly basis pursuant to an **After Action Review (AAR)** to be completed by the lab members (see section 4.a. for an explanation of the After Action Review process). These quarterly “effectiveness reports” will be reviewed by the respective service line leader(s), Rick Rosenthal, Mike Lippman, David Brockway, Richard Smith, and Mark Springer.

b. Idea Submission Process

Once an idea is generated through a **Tax Lab** or other means, it must be entered into the **Idea Submission Process**. The purpose of the Idea Submission Process is to collect the tentative solutions to tax related problems and screen them for technical and revenue potential. The **TIC In-Box** is the proper repository for the collection of submitted ideas.

Ideas may be submitted to the TIC In-Box in the form of Tax Knowledge Sharing (TKS) documents or an **Idea Submission Form (ISF)**. The ISF is a questionnaire that makes a preliminary assessment of the tax technical, business issues, and revenue potential associated with the potential solution. For any solutions generated in a Tax Lab, the **TIC Manager** should identify the appropriate resource to complete the ISF.

Once submitted to the TIC In-Box, the **TIC Administrative Assistant** retrieves the submissions and enters them into the **TIC Database**. The TIC Administrative Assistant will then forward the ISF or TKS submissions to a designated **TIC Leadership Team** member for preliminary review.

c. Technical/Revenue Screening

The next step in the **TIC Solution Development Process** is the preliminary technical and revenue screening of the submitted idea. Initially, the **TIC Manager** reviews the submitted **Idea Submission Form (ISF)** for completeness. The TIC Manager will return any incomplete ISF submissions or submissions of TKS documents to the **Idea Submitter** and request a completed ISF be returned. The completed ISF should be returned via the **TIC In-Box**. The **TIC Administrative Assistant** will forward the completed ISF to the TIC Manager and update the **TIC Database**, as appropriate.

The TIC Manager should present the completed ISF to the **TIC Leadership Team** who will decide which solution group should conduct the technical and revenue screening of the idea. The TIC Manager will forward the ISF to the agreed upon solution group and inform the TIC Administrative Assistant who will, in turn, inform the Idea Submitter that the idea has been forwarded to the appropriate solution group for screening.

The TIC Manager will schedule the review of the idea with the appropriate **Solution Group Leadership**, the **Tax Lab Participants** (if appropriate), and the Development Leader. This review can take place during a **Tax Lab**, or under the appropriate solution group protocol. The **Solution Development Partner** will work with the Solution Group Leadership and the **Tax Lab Participants** to perform the review of the idea and make the decision on whether it should continue in the TIC Solution Development Process. The criteria used to make this determination includes the technical viability of the idea, the idea's revenue generation potential above the **Solution Revenue Threshold**, and a business case for developing the solution, including initial target list, marketing considerations, and preliminary technical analysis. The TIC Manager may also need to consult with the **DPP - Assurance Rotational** on accounting issues to complete the screening process.

If an idea passes this initial screening, the TIC Manager should inform the Idea Submitter that the idea has entered the TIC Solution Development Process. The Development Leader or TIC Manager must complete part two of the ISF and submit it to the TIC In-Box. The **Development Leader**, TIC Leadership Team, and the TIC Manager must then identify the appropriate **Solution Development Team** to work on the development of the solution. The TIC Administrative Assistant will also enter the idea into the TIC database/tracking system and set up a contract number for solution development.

If it is determined that an idea should be developed into a solution, the TIC Manager will inform the TIC Administrative Assistant as to why the idea did not pass the initial screen and recommend whether the idea should be submitted to the **Tax Services Idea Bank**. The TIC Manager also provides input on the appropriate amount of the cash award that should be paid to the **Idea Submitter**.

d. Identify Deployment Team

Once an idea has passed the screening process, the **National Deployment Champion** should be identified. It is important to identify the Development Champions early in the process since they can contribute to the **TIC Solution Development Process** effort. The **TIC Marketing Group, Solutions Group Leader** or **Area Managing Partner (AMP) – Tax, TIC Leadership Group, Development Leader**, and **Tax Industry Leader** work together to identify the appropriate **Solution Deployment Team** and tentative **Deployment Champions**. Once identified, the **Solution Group Leader** or **Area Managing Partner – Tax**, will contact the Deployment Champions to discuss their willingness to serve in that role.

e. **Initial DPP Review**

DPP – Tax and **DPP – Assurance** notification should also occur once an idea has passed the initial screening process. Notification will provide an opportunity for **DPP – Tax** and **DPP – Assurance** feedback on the new solution at a relatively early stage in the solution's development. This should increase the speed with which a decision can be made regarding the priority of the development of the solution.

The **TIC Administrative Assistant** should forward to the **DPP-Tax In-Box** and the **DPP – Assurance Rotational** parts one and two of the **Idea Submission Form (ISF)** for ideas that have passed the initial screening. The **DPP – Tax PIC** will assign an appropriate **DPP-Tax Reviewer** to the solution for its development. The **DPP-Tax Practice Administrator** will email the **DPP – Tax Reviewer's** name to the **TIC-DPP Liaison**, with a copy to the **DPP – Tax Reviewer**, the **TIC In-Box**, and the **TIC Manager**. The **TIC Practice Administrator** will post the **DPP – Tax Reviewer's** name to the **TIC Database**. The **DPP – Tax Reviewer** should provide initial comments on the solution, if any, to the **TIC – DPP Liaison**, with copy to the **TIC Manager**.

The **DPP – Assurance Rotational** should also review parts one and two of the **ISF** for possible assurance issues related to the idea. The **DPP – Tax Rotational** should consult with the **DPP – Assurance Income Tax Topic Team Leader** to assign other **DPP – Assurance** resource(s) to the solution, if necessary, and consult with the **TIC-DPP Liaison** as needed. If additional **DPP – Assurance** resource(s) are to be used, their names should be emailed to the **TIC – DPP Liaison**, with a copy to the **TIC In-Box**, **DPP – Tax In-Box**, and the **TIC Manager**. The **TIC Practice Administrator** will post the **DPP – Assurance** resource(s) associated with the solution to the **TIC database**. Any comments on the solutions should be made to the **TIC – DPP Liaison**, with a copy sent to the **TIC Manager**.

2. **Develop Solution and Prepare for Launch**

Once an idea emerges from the Collect and Screen Phase, it is ready for complete solution development and launch preparation. The majority of solution development work carried out by the **Tax Innovation Center (TIC)** is accomplished during this phase. Development of a standardized toolkit is the primary focus and the **TIC** is responsible for managing this process. The standardized toolkit accompanying a **Tax Solution Alert (TSA)** released by the **TIC** allows

for more efficient and cost-effective delivery of the solution for clients with similar fact patterns. A second, equally important goal of this phase is helping to ensure that the firm's high standards for tax solutions are maintained.

a. Project Management

A project management plan should be adopted at the beginning of this phase of the **TIC Solution Development Process**. A successful project management plan should monitor the progress of solution development, including tracking solution development costs, anticipating and managing development roadblocks and bottlenecks, and avoiding unnecessary solution development costs.

The **TIC Manager** will develop a **Solution Development Workplan**, which should list all the steps necessary for the development of the specific solution. The **TIC Manager** should gather inputs from the **Solution Development Team** on the steps necessary to develop the solution. Once a draft of the Solution Development Workplan is completed, the TIC Manager should meet with the **Development Leader** to discuss the Solution Development Workplan and make any revisions, if necessary. Once the Development Leader reviews and approves the final Solution Development Workplan, the TIC Manager should distribute it to the Solution Development Team.

Throughout the **TIC Solution Development Process**, the TIC Manager is responsible for revising and updating the Solution Development Workplan as work on the development of the solution progresses and when other revisions are necessary. The **TIC Administrative Assistant** will also update the **TIC Database** as the status of the project changes.

b. Solution Technical Development and Toolkit Creation

Technical development of the solution is a continuation of the work that was completed during its initial technical screening. The objective of technical development in this phase of the **TIC Solution Development Process** is to thoroughly research and document the tax technical and non-tax issues associated with the solution and resolve all such matters. The major deliverable resulting from solution technical development is a **White Paper** addressing the above mentioned issues.

The **Solution Development Team** made up of the **Development Leader**, **Content Contributor**, and the **TIC Manager**, should hold regular meetings to discuss the technical tax and non-tax issues that must be addressed in the White Paper. Each Solution Development Team member will be assigned issues associated with the development of the solution. Resolution will be needed for any tax technical, assurance, regulatory, industry, general business, or exit strategy issue that arise during solution development. Each Solution Development Team member is responsible for the resolving each issue assigned to them, updating the team as to where the resolution process stands, identifying additional issues that may arise during the resolution of each issue, and informing the Solution Development Team of these new issues. Once technical approval of all sections of the White Paper occurs, it must be sent to **DPP – Tax** for review.

Additional **Toolkit Item** may also be created during the technical development of a solution. A determination of what additional Toolkit Items to develop should be made during meetings of the Solution Development Team. The responsibility for Toolkit Item development will be assigned to a member of the Solution Development Team. They will be required to provide a draft of each Toolkit Item to the TIC Manager for review. Once the Toolkit Item is reviewed by the *TIC Manager*, it will be submitted to the Content Contributor and the Development Leader for WNT technical sign-off. Once the Toolkit Item receives appropriate WNT technical sign-off, it must be submitted to DPP – Tax for review.

Additional Toolkit Items may include:

-
-
-
- ICV Presentation
-
- Computer Based Model
- Implementation Workplan
-
- Representations Letter
- Critical Issues and Talking Points Document
- Abstract of the solution to be posted to the TIC homepage and kpmgtax.com

Two items that almost always must be created in addition to any above are:

-
- Power Point Presentation for Solution Launch Conference Call [**Not referenced since a Powerpoint presentation; but attached on email**]

The **Tax Solution Alert (TSA)** is used as the official notification to the tax and assurance partners and managers and all tax professionals of the launch of a solution. The first section of the TSA, the Digest, includes a description of the solution, who delivers the solution, solution pricing, and the tier of the solution. The remaining sections of the TSA expand upon the description given in the Digest and include:

- Solution Profile;
- Optimal Target Characteristics;
- Typical Buyer;
- Pricing and Fee Arrangements;
- Service Delivery Team;
- An Assessment of the Competition/KPMG's Strengths;
- List of Toolkit Documents; and
- Action Required by the Client Service Professional.

c. Beta Test

A **Beta Test** of a prospective solution may occur as part of the **TIC Solution Development Process**. The decision to conduct a Beta Test is made by the **Solution Development Team** and **TIC Leadership Team** after the idea has been reviewed by a member of the appropriate WNT technical group. Beta Tests are used to field test the technical viability and/or the market potential of a prospective solution. Since a Beta Test occurs prior to mass marketing of the idea, the entire solution approval process need not be completed prior to the Beta Test.

The Beta Test process begins with the **Solution Champion, Development Leader, and TIC Leader** considering whether the strategy should be presented to a limited number of clients to assist in further identifying solution technical and implementation issues. If a Beta Test is warranted, the Solution Champion, Development Leader, and TIC Leader must determine the appropriate **Beta Test Implementation Team**.

Appropriate Beta Test targets may be obtained through a response to a **Beta Test Opportunity Alert** issued to the tax partners. A Beta Test Opportunity Alert is designed to alert the tax partners to new ideas that have been initially screened by WNT for market potential and technical viability, and for which we are now seeking Beta Test engagements. Tax partners are notified of a Beta Test Opportunity Alert on the weekly **Solution Launch Conference Call**. Up to three Beta Test engagements for ideas may be performed, after which a decision will be made whether to proceed with full development and deployment of this idea as a solution.

The **Solution Champion and Development Leader** will approach the appropriate target for the Beta Test to obtain approval for the Beta Test. This initial client contact should not be made until a draft of the **White Paper** associated with the solution has been completed. The Beta Test Implementation Team will conduct the Beta Test after the client has agreed to the engagement. Upon completion of the Beta Test, **Content Contributor** will gather feedback from the Beta Test Implementation Team, and incorporate this information into the appropriate **Toolkit Item**.

d. Targeting and Market Assessment

A substantial part of the **TIC Solution Development Process** is spent determining the market potential and probable targets for a new solution. This includes developing and refining a meaningful revenue estimate for a new solution based on the perceived marketplace potential and identifying those prospects that are most likely to purchase the solution. Both of these steps are taken to help maximize the success of the solution in the marketplace. The **TIC Marketing Group** is the primary resource responsible for targeting and market assessment.

The TIC Marketing Group must first gain an understanding of the proposed solution. This is done through a review of the **Idea Submission Form (ISF)**. The TIC Marketing Group, working with the **Solution Development Partner** and the **TIC Manager**, may refine the ISF so it contains the key targeting criteria to facilitate revenue estimation and prospect identification. Once this is complete, the TIC Marketing Group should be able to gain a comprehensive understanding of the solution and help identify key market criteria to assess the given market for the solution.

Next, the TIC Marketing Group must validate the solution revenue potential estimated on the ISF. This validation is primarily based on the results from market research and market assessment, and the business case supported by the **Solution Development Team** knowledge of the market. Key steps in making a market assessment include obtaining and documenting any knowledge of competitive solutions and their estimated market share, differentiating characteristics, etc., assessing marketplace needs and evaluating buyer's reception to the new solution, and conducting primary and secondary research to estimate market potential.

Estimating market potential involves working directly with the **TIC Marketing Leader** and **National Marketing Directors** to understand the solution and key criteria which defines a prospect, performing a search and compiling a preliminary list of prospects that meet the solution criteria, considering alternative ways of defining the market to validate market estimates, and gathering competitive information. The **Deployment Champion** and **Development Leader** will review this market assessment and provide feedback to the **TIC Marketing Group**. The TIC Marketing Group will provide recommendations regarding the ability of the solution to achieve the **Solution Revenue Threshold**.

The preliminary list of targets is developed by the **TIC Marketing Group**, the **Tax Marketing Director**, and the **Market Research Group**. Once the Market Research Group is briefed on the solution, the groups meet to discuss the research methodology and define alternatives to yield the most accurate prospects. The TIC Marketing Group should then meet with the **Development Leader**, **Deployment Champion**, and the Market Research Group to discuss initial solution target criteria and the possible research methodology as previously developed. As a result of this meeting, the Marketing Research Group will conduct secondary, and if necessary, primary target research, and provide a sample target list to the *TIC Marketing Group* and Tax Marketing Director. The Tax Marketing Director, the Deployment Champion, and the Development Leader will periodically review and revise the target list as necessary based on changes to the solution and changes in the marketplace.

Finally, the go-to-market strategy should be developed after the initial targeting list is refined. The TIC Marketing Group, the Tax Marketing Director, the Deployment Champion, the **Partner-in-Charge of the BDMs**, and the **Area Sales Directors** will meet to discuss the go-to-market strategy, taking into account the solution's revenue potential, the market assessment, and the refined target list.

e. Preparation of Deployment Team

Once the **Solution Deployment Team** has been identified, they should participate in weekly or bi-weekly conference calls. During these conference calls, the **Development Leader** and **National Deployment Champion** can inform the Solution Deployment Team about the progress of the development of the solution. The Solution Deployment Team can also discuss the initial targeting list prepared by the **TIC Meeting Group**, and make necessary additions and/or amendments to that list based on the **Area Solution Champions** industry knowledge.

The **Deployment Team** must also be prepared for the initial solution launch. The TIC will assist the Development Leader in developing appropriate training materials on the technical and sales aspects of the solution and providing the training to the Deployment Team. Included in the training materials should be a training agenda with the major points to be covered, a Power Point presentation describing the technical and non-technical aspects of the solution, any other **Toolkit Item** that have been developed, and the refined target list.

Once the Deployment Team is trained, the Deployment Champion, working with the Development Leader, **TIC Manager**, and **TIC Leader**, must determine the best method of introducing the solution to the tax practice. Included in this determination is the appropriate level of security or restrictions that should be placed on the Toolkit Items associated with the solution.

f. DPP Review

After a solution has WNT technical approval, it must be approved by **DPP – Tax** and **DPP – Assurance**. This review is intended to minimize risk to the firm by ensuring that professional practice and risk management issues associated with the solution are addressed. It includes documenting that each tax solution that ultimately is deployed has satisfied the firm's tax technical, solution development, and risk management standards. It also includes determining the order of required approvals in a manner that efficiently uses firm resources and defining the information required to be submitted to each party involved in the final approval process. DPP – Tax and DPP – Assurance review focuses primarily on the **White Paper** and **Toolkit Item** generated in the **TIC Solution Development Process**. The **TIC Manager** will submit the **White Paper** and Toolkit Items to **DPP-Tax In-Box** and the **DPP – Assurance Rotational** with a copy to the **TIC In-Box** and the **TIC-DPP Liaison** for review.

The Assigned DPP – Assurance resources will correspond with the TIC – DPP Liaison to address the extent of the accounting information that should go into the solution materials. They will work together to draft such language and agree on a time table for resolving accounting issues. This information will also be forwarded to the **TIC Manager** and the **DPP – Assurance Administrator**. The DPP – Assurance Administrator will update the tax solution folder kept in **DPP – Assurance** with copies of any correspondence between DPP – Assurance resources and the **TIC-DPP Liaison**.

The **DPP – Tax Reviewer** will correspond with the TIC – DPP Liaison to resolve all tax issues associated with the solution, with a copy of any correspondence to the TIC Manager. The **DPP-Tax Reviewer** will also correspond with the **DPP – Tax Independence Reviewer** to resolve any independence issues and obtain approval of the solution.

Once all comments and edits to the solution materials are received and finalized, final approval via written sign-off must be given by the TIC Manager, the appropriate WNT Technical Resource(s), and the **Partner in Charge (PIC) – DPP-Tax**. The PIC DPP – Tax will send final approval for the solution to the TIC In-Box. The **TIC Practice Administrator** will send the documents received from DPP – Tax to the **TIC Administrative Assistant** for final formatting.

The TIC Administrative Assistant will review the current document formats, compare them with **TIC Templates**, and discuss any substantive changes to the solution documents with the TIC Manager. If changes are made to the documents that are other than cosmetic, the TIC Administrative Assistant should resubmit the documents to the PIC DPP – Tax for review, with a copy to the TIC – DPP Liaison and the TIC Manager.

The PIC DPP – Tax should discuss these changes with the TIC – DPP Liaison and email the final, approved versions of the solution materials to the TIC – DPP Liaison, with a copy to the TIC Administrative Assistant, the TIC In-Box, and the TIC Manager.

It is important to note that prior to beginning the first solution development assignment and throughout the solution development process, the **Development Leader** and the **Content Contributors** should review the all tax and other Professional Practice Letters related to development of the **Tax Solution** and identify all professional practice and risk management tasks that must be completed, procedures to be followed, and issues to be resolved when developing the Tax Solution. The current tax and other Professional Practice Letters can be found on the **Department of Professional Practice - Tax Homepage**.

The TIC Manager should also be intimately familiar with the professional practice procedures that relate to the development of the Tax Solution.

3. Launch and Deploy Solution

The **Tax Innovation Center (TIC)** primary role in the Launch and Deploy Solution Phase of the **TIC Solution Development Process** occurs during the early stages of market distribution. The **TIC Manager, TIC Leader, TIC Marketing Director, and TIC Administrative Assistant** are fully involved in developing the solution's market deployment strategy and coordinating the distribution, or "roll-out," of the solution. With very few exceptions, every new solution is first announced internally during the weekly **Solution Launch Conference Call**. The call, organized by the Vice Chairman Tax - Operations and the **TIC Leadership Team**, includes all tax partners, **Area Tax Marketing Directors**, and the Business Development Managers (BDMs). The TIC is also primarily responsible for initially posting and maintaining the most recent versions of solution toolkits either on the TIC Home Page or a private, limited access folder maintained on Outlook.

Although involved to a lesser extent in implementing new solutions, the TIC plays a role in implementation by monitoring developments from solution engagements to obtain feedback that may help improve a specific solution, solution toolkit item or that might lead to an improvement of the TIC Solution Development Process.

a. Solution Launch

The official launch of the solution occurs on the **Solution Launch Conference Call**. The **TIC Manager**, working with the **Solution Champion** and **Development Leader**, develops a

Solution Launch Power Point Presentation, which is used to introduce the solution on the conference call. This presentation should describe the technical and non-technical aspects of the solution, identify appropriate targets for the solution, list the toolkit items associated with the solution, and list the **National** and **Area Deployment Champions** for the solution. The **TIC Administrative Assistant** distributes the Solution Launch Power Point Presentation and the solution target list to the Solution Launch Conference Call participants prior to the conference call. The **National Deployment Champion** and/or the **Development Leader** will discuss the solution and the target list on the Solution Launch Conference Call.

Once the solution is approved by DPP, the TIC Administrative Assistant should send the **Tax Solution Alert (TSA)** via e-mail to the postmaster for distribution. The TSA is also posted on the **TIC Homepage**, with links to all commonly available toolkit documents approved to date.

b. Solution Deployment

Solution Development Team responsibilities do not end after the initial launch of the solution. The **Development Leader**, **National** and **Area Deployment Champion(s)**, **TIC Manager**, and **Content Contributor** should participate in actual engagements or **Beta Tests**, if applicable. The Development Leader and Content Contributor should also continue to participate in Solution Development Team conference calls that discuss feedback from sales presentations and live client engagements. This will also allow the Solution Development Team to revise existing **Toolkit Items** and identify additional Toolkit Items that may be appropriate for the solution. The Development Leader will also communicate toolkit revisions and additions to the toolkit to the **National Deployment Team** on the **Solution Deployment Team** conference call.

All additional Toolkit Items must be reviewed and approved by all the appropriate technical and risk management resources before they will be released to the Solution Deployment Team. The review process is the same as outlined in Section 2.b. Once reviewed and approved, all updated and additional Toolkit Items should be distributed to the Solution Deployment Team.

It should be noted that any draft documents produced during the development of the Tax Solution, including both drafts that are made part of the final toolkit and draft documents determined not to be included as a toolkit item, are to be destroyed, whether in electronic or printed form. Please see Chapter 10 of the **Professional Practice Manual** for a discussion of KPMG's document retention policies.

After the launch of the solution, the TIC Manager must still monitor the project against the **Solution Development Workplan** in order to keep the project moving and to anticipate and minimize the impact of distribution barriers. The TIC Manager should periodically update the Solution Development Workplan and Toolkit Items as deployment of the solution progresses and when other revisions are necessary.

Within one week prior to the official **Monday Tax Solution Revisit**, the **TIC Marketing Group**, **Deployment Champion**, and the **Tax Marketing Director** participate in the **Targeting Revisit Conference Call** to measure the success of the solution based upon the results of **Initial**

Client Visit (ICV) and engagement wins, using the market assessment techniques outlined in Section 2.d. The target list is revised or expanded as necessary.

4. Evaluate and Improve Solution

Once a solution has been distributed, and implementation of the deployed strategy is underway, continuous follow-up to help ensure the **Solution Development Team's** success is critical. During this follow-up phase, the **Tax Innovation Center (TIC)** plays a role in a number of key areas, including:

- Assisting with solution and process improvements;
- Formulating new ideas from solution deployment experiences;
- Performing a cost/benefit analysis for the development effort; and
- Providing input for reward and/or recognition of professionals involved in idea generation, development, and deployment.

Through this involvement, coupled with on-going feedback from the Solution Deployment Team, additional modifications and improvements to individual solutions and **the TIC Solution Development Process** should occur.

a. After Action Review

An important part of evaluating the success of both the **TIC Solution Development Process** and the ability of the **Solution Deployment Team** to successfully sell and implement the solution is the performance of an **After Action Review (AAR)**. An AAR is a formal, structured discussion of an event by those who participated in the event. Although an AAR is not required, it can be used to guide the event members in reviewing their performance as a group. It is used to understand why the team did or did not achieve its objectives. During the AAR, the team should discuss what did they initially set out to do, what actually happened, what can be learned from the experience, and what can be done to sustain and improve the next performance.

The AAR is an opportunity for the Solution Development Team to review the TIC Solution Development Process. The Solution Development Team can better correct deficiencies and sustain strengths in the TIC Solution Development Process by carefully evaluating and comparing the actual output of the TIC Solution Development Process with the intended outcome. By focusing on the TIC Solution Development Process standards and by describing specific observations, the Solution Development Team can identify strengths and weaknesses and together decide how to improve performance.

The AAR can obtain learning along three time horizons:

- short-term: the team can develop short-term tactical actions for AAR (therefore, the **AAR Facilitator** may act as a coach for the Solution Development Team);
- mid-term: the entire TIC Solution Development Process for a particular solution may be modified; and

- long-term: the TIC Solution Development Processes for all solutions may be modified or changed.

During planning, the **TIC Manager** should schedule an AAR after each milestone in the TIC Solution Development Process. Initially, an AAR should be scheduled as soon as the toolkit items are sent to DPP-Tax for approval. This ensures the allocation of time and resources to conduct AARs and reinforces the important role AARs play in improving the TIC Solution Development Process.

The AAR process has four distinct parts: planning for the AAR meeting, the AAR meeting, reviewing the results of the meeting, and follow-up.

i. Planning for the AAR Meeting

The key events and activities to be observed during the **TIC Solution Development Process** should be identified and communicated to the **Solution Development Team** before the **After Action Review (AAR)**.

The time and place for the AAR should be scheduled immediately after the toolkit documents are approved. Typically, the TIC Solution Development Process AAR should last approximately 1 hour. The **TIC Administrative Assistant** should schedule a conference room or set-up a conference call for the AAR.

The purpose and desired outcomes of the AAR should be defined before the meeting. The purpose of the TIC Solution Development Process AAR is to guide the Solution Development Team in reviewing their performance as a group. The desired outcome of the TIC Solution Development Process AAR is to ascertain what the team initially set out to do, what happened, why/how it happened, and develop actions to sustain what went well and improve performance.

The participants are identified before the meeting. The entire Solution Development Team should be invited, although all team members need not attend. This includes people from partner to staff, people inside and outside the development team for the particular solution (including assurance people, industry experts, consultants, etc.).

An **AAR Coordinator** and **AAR Facilitator** should be appointed. The AAR Coordinator should not be the **Development Leader**. The AAR Coordinator will take care of communications with participants, and help plan the AAR. The AAR Coordinator may also be the note taker. Alternatively, a member of the Solution Development Team will be the note taker. However, an administrative person should not be the note taker. In general, the AAR Facilitator should be available when it is convenient for the Solution Development Team to perform the AAR.

The AAR Coordinator and AAR Facilitator should discuss the AAR and the process for completing **AAR Standard Facts Form**. They will prepare the **AAR Informal Agenda** including AAR roles (AAR Facilitator, time keeper, ending time, note taker). The completed AAR Standard Facts Form should include the names of the Solution Development Team

members no matter how small the role (*e.g.*, KPMG Consulting, other tax, TSP, SALT, assurance, ECS, industry expertise, etc.), and the titles/roles of the Solution Development Team members.

Once the AAR Informal Agenda and the AAR Standard Facts Form are completed, the AAR Coordinator sends out the AAR Standard Facts Form and the **AAR Agenda Template** listing the AAR objectives, outputs, and suggested ground rules to all participants. The AAR Coordinator will obtain a time commitment from each attendee (beginning and ending time).

ii. AAR Meeting

The meeting begins with a restatement of the purpose and desired output of the **TIC Solution Development Process**. The **AAR Facilitator** states the type of participation desired and demonstrates that the **After Action Review (AAR)** values ideas, opinions, and questions. The AAR Facilitator suggests ground rules and ask if there should be others. The AAR roles of the AAR Facilitator, participants, note taker, and **AAR Coordinator** are then defined.

The AAR Facilitator proceeds with a review of the **AAR Standard Facts Form**. The AAR Facilitator states what the group set out to do. The answer to this should be broader than “develop Solution X.” This discussion will include a review of the key tasks involved, the conditions under which each task needed to be performed, and the acceptable standards for success.

Next, the AAR Facilitator initiates a discussion of “what happened.” This can be along the lines of chronological events, key events, themes, or issues. The AAR Facilitator proceeds by asking questions that relate to the TIC Solution Development Process, such as:

- How were the team members selected?
- How was the team communication and interaction?
- How was the interaction with Assurance and/or other third parties involved in development of a Tax Solution?
- What happened with the toolkit development?
- What happened with strategy marketing and the beta test?
- What happened with Deployment team training?

The AAR Facilitator should seek maximum participation. The AAR Coordinator should map out each time someone speaks to objectively know who is speaking. The AAR Facilitator is responsible for maintaining focus on AAR objectives. The AAR Facilitator concludes the meeting by summarizing the actions necessary to sustain and improve performance.

iii. Reviewing the Results of the AAR Meeting

Reviewing the results of the **After Action Review (AAR)** involves determining what went well, what should have been done differently to improve effectiveness, and what actions are necessary to sustain and improve performance.

iv. Follow-Up

During the follow-up phase of the **After Action Review (AAR)**, tasks that require retraining should be identified. Additionally, feedback from the meeting should be shared with the entire **Solution Development Team**.

b. Cost/Benefit Analysis

Another aspect of this phase of the **TIC Solution Development Process** includes a cost/benefit analysis of the development process. The **TIC Practice Administrator** should monitor the project development costs and compare the cost to the benefits as **Initial Client Visit (ICV)** and signed engagements are completed and reported in OMS. The **TIC Leadership** will determine whether the costs to implement the solution outweigh the benefits and decide whether the contract needs to be closed. The **TIC Practice Administrator** will review the final contract runs after the contract is closed.

c. Six-month review

The **National** and **Area Deployment Champions**, the **TIC Marketing Group** and the **TIC Leadership Team** should communicate after six months to assess the viability and/or market potential of the solution in light of changes in the marketplace, the amount of revenue generated, etc. The possibility of converting the solution to a Tax Service Idea should be considered at this time.

GLOSSARY

After Action Review (AAR)	A formal, structured discussion of an event by those who participated in it, with its purpose to guide the event members in reviewing their performance as a group. AARs can be used for both the solution development and deployment process.
AAR Coordinator	Person responsible for communications with AAR participants, help with planning the AAR, and note taking during the AAR. They should not be the Development Leader.
AAR Facilitator	Facilitates the AAR including the type of participation desired, review of the AAR Standard Fact Form, initiating a discussion of “what happened,” asking questions that relate to the TIC Solution Development Process, and concluding the meeting by summarizing the actions necessary to sustain and improve performance.
AAR Standard Facts Form	Form completed by the AAR Coordinator and AAR Facilitator which contains the agreed upon facts relating to the particular event subject to an AAR.
Area Deployment Champion(s)	Tax professionals with oversight responsibility for deployment of a Tax Solution in their geographic area. These professionals, along with the National Deployment Champion, make up the Deployment Team.
Area Managing Partner (AMP) – Tax	Tax Partner-in-Charge of one of KPMG’s six geographic areas.
Beta Test	Field tests of the technical viability and market potential of prospective Tax Solutions.
Beta Test Opportunity Alert	Notice sent to alert the tax practice to new Tax Solutions that have been initially screened by WNT for market potential and technical viability, and for which Beta Tests are sought.
Content Contributor	Professional who contributes content to a Toolkit, usually in the form of contributing to the development of a Toolkit Item.
Department of Professional Practice (DPP) – Assurance	Provides support to the firm in the areas of accounting, auditing standards, reporting, independence, and SEC matters.

Department of Professional Practice (DPP) – Tax	Supports the national industry and Tax Solution groups in providing quality tax consulting and compliance services to their clients. DPP-Tax reviews and approves the release of all new Tax Solutions.
DPP - Assurance Rotational	Senior Manager in DPP-Assurance on rotation to the Tax Innovation Center. Consults with Tax Labs and Tax Solution development teams regarding assurance issues related to Tax Solution development.
DPP-Tax In-Box	Outlook email box: <i>US-DPP Tax Inbox</i> .
DPP-Tax Practice Administrator	DPP-Tax resource responsible for coordinating the DPP review of a Tax Solution.
DPP-Tax Reviewer	DPP-Tax professional assigned to review a Tax Solution to reduce risk to the firm by addressing professional practice and risk management issues associated with the solution.
Idea Submission Form (ISF)	A standard form, Part I of which is completed by the idea submitter and gives an overview of the solution, and Part II of which is completed by the TIC Manager in collaboration with the Tax Lab that screens the idea. Part II of the ISF includes the names of the TIC Manager and the TIC-DPP Liaison.
Idea Submission Process	Involves collecting tentative solutions to tax related problems and screening them for technical merit and revenue potential to determine if they should continue in the TIC Solution Development Process.
Idea Submitter	Person who files out the ISF and places an idea into the Idea Submission Process.
Initial Client Visit (ICV)	The first “face-to-face” visit with a client/target with respect to a particular Tax Solution.
Monday Tax Solution Revisit	Part of the Solution Launch Conference Call where a Tax Solution is reviewed to determine if it still meeting the Solution Revenue Threshold and whether to Client Target List should be modified.
National Deployment Champion	Tax professional (usually a partner) with oversight responsibility for the deployment of a Tax Solution. Generally, this individual is in charge of the Deployment Team.
Opportunity Management System (OMS)	Electronic database used to track targets, target attributes, key contacts and solutions sold/being considered for introduction.

Partner in Charge – Tax Solution Development (PIC – TSD)	The Partner responsible for the day-to-day management of the TIC Solution Development Process and all full-time solution development resources. Currently, Mark Springer.
Partner in Charge (PIC) – DPP-Tax	The Partner responsible for risk management review of solutions in the TIC Solution Development Process. Currently, Larry Delap.
Solution Deployment Team	Group of tax professionals charged with leading the sales efforts for a particular Solution into the marketplace. The Team is lead by the National Deployment Champion and by the Area Deployment Champions within their respective regions. The Team also receives support from the Solution Development Team, the TIC Marketing Group, and the Solution Group related to the deployment of the Solution into the marketplace.
Solution Development Leader	Tax professional, usually a partner, in charge of technical development effort for a particular Tax Solution.
Solution Development Process (SDP)	The process by which a tentative tax idea becomes a turnkey, leveragable Tax Solution.
Solution Development Team	Group of professionals charged with the technical review and documentation of a Tax Solution, and the creation and assembly of the toolkit items for use by the Solution Deployment Team in presenting and implementing a Tax Solution. The team is lead by the Development Partner and includes content contributors, members of the TIC Marketing Group, and a TIC Manager who has responsibility for the procedural aspects of the Solution Development Process.
Solution Development Workplan	A listing of all steps necessary to complete the TIC Solution Development Process
Solution Group	One of KPMG's five specialty tax practices – Federal (including Compensation & Benefits, Stratecon, Exotax, Mergers & Acquisitions, Tax Controversy Services, and Tax Management Services), International Services (IS), International Executive Services (IES), Personal Financial Planning (PFP), and State and Local (SALT).

Solution Group Leadership	Professionals associated with a specific Tax Solution who, along with the TIC Manager and Development Leader, determine whether newly submitted ideas should continue in the TIC Solution Development Process. Members are likely to make up the Solution Development Team.
Solution Launch Conference Call	A telephone conference call, usually held on Monday afternoons (EST), organized by the Vice Chairman - Tax Operations and the TIC during which solutions that are ready for deployment and Beta Test Opportunity Alerts are first introduced to the firm's tax leadership group.
Solution Launch Power Point Presentation	Presentation used to introduce the Tax Solution on the Solution Launch Conference Call
Solution Revenue Threshold	The targeted amount of revenue that an idea must reasonably be projected to generate in order to be considered for solutionization. Currently, the Solution Revenue Threshold is \$5 million over the solution's life cycle or, if the idea is expected to remain viable for an extended amount of time, annually.
Tax Industry Leader	The tax partner responsible for overseeing the identification of marketplace opportunities for clients/targets in a specific industry (e.g., Banking).
Tax Innovation Center (TIC)	The group of professionals within Washington National Tax (WNT) which serves as the central resource group supporting solution and service development initiatives of the firm's Tax Solution groups. The Tax Innovation Center is managed by the National Partner-in-Charge – Tax Solution Development and the TIC Leadership Team.
TIC Administrative Assistant	Responsible for assisting the TIC administratively during the TIC Solution Development Process.
TIC Database	An excel workbook in which the TIC tracks the progress of ideas that have been submitted for Tax Solution development. Posted to the following Outlook folder: <i>US-Tax Solutions/DPP/Solution.xls</i>
TIC In-Box	Outlook email box: <i>US-Tax Innovation Center</i>
TIC Leader	One of the Tax Innovation Center partners. Responsibilities of the TIC Leaders with respect to a particular Tax Solution include overseeing the movement of the Tax Solution through the solution development process, facilitating coordination among various groups involved in the process, and quality control. The TIC Leader assigned to a solution is recorded in the Solution Development Log.

TIC Leadership Team	The group of professionals within the TIC, led by the National Partner-in-Charge -- Tax Solution Development, charged with oversight responsibilities for the entire solution development process and certain deployment issues. In addition to overseeing overall development efforts for all solutions, the TIC Leadership Team is charged with developing and continually refining the SDP.
TIC Management Team	The group of tax managers charged with managing the process of developing a tax idea into a Tax Solution for a particular tax technical (functional) or solution area. The TIC Management Team also includes the TIC Leadership Team members.
TIC Manager	Member of the TIC Management Team. TIC Managers reside within their functional/solution groups (<i>e.g.</i> , SALT, Compensation and Benefits, Federal Tax, etc.) and are responsible for overseeing the process of developing solutions within their respective groups. TIC Management Team members serve as the primary link between the Solution Groups and the TIC Leadership Team.
TIC Marketing Group	The TIC Marketing Group is responsible for assisting the Development Team with (1) determining if the market for an idea is sufficient to meet the Solution Revenue Threshold; (2) developing a target list for initial client visits; and (3) Bringing in appropriate resources to assist in creating the go-to-market strategy. The TIC Marketing group also assists the Solution Deployment Team with updated marketing information relating to the Solution. The TIC Marketing Group works closely with all of the firm's marketing resources including Market Research, Tax Marketing, Practice Development Coordinators, Business Development Managers, and the Proposal Group (Sales Workbook).
TIC Practice Administrator	Practice Administrator for the TIC responsible for initial retrieval of Idea submissions to the TIC In-Box and maintenance of the TIC Database.
TIC Solution Development Process	A four-phased process used by the TIC to develop and deploy solutions that was created and employed to help ensure consistency, quality and results in the solution development process. The phases include: 1) Collect and Screen Ideas; 2) Develop Solution and Prepare for Launch; 3) Launch and Deploy Solution; and 4) Evaluate and Improve Solution.

TIC-DPP Liaison	Member of the Tax solution development team who serves as the contact point with DPP-Tax and DPP-Assurance for a Tax Solution under development. This person may also serve as the TIC Manager for the solution.
Tax Lab	A meeting designed to accomplish, generally, one of three solution related tasks: (1) screen new ideas to determine if the idea should be moved forward or rejected for solutionization; (2) prioritize activities of solution development professionals; and (3) review progress on ideas that were previously accepted for solutionization.
Tax Lab Leader	Facilitator of the discussion by the Tax Lab Participants of the ideas identified for consideration during the Tax Lab.
Tax Lab Participants	Tax professionals from a functional or solution group who participate in idea generation during tax labs.
Tax Lab Summary	A write up of the ideas discussed at the Tax Lab and the outcomes of those discussions, including action items and parties responsible.
Tax Marketing Director	Professional in charge of National Marketing for a particular Solution Group.
Tax Service Idea	Tax idea that was not selected for the TIC Solution Development Process, which was developed for inclusion in the Tax Services Idea Bank.
Tax Services Idea Bank	Searchable repository for ideas that have not been selected to continue in the TIC Solution Development Process, but are developed into Tax Service Ideas.
Tax Solution	Tax idea that has been subjected to the TIC Solution Development Process.
Tax Solution Alert (TSA)	A notice sent to the Tax professionals and all KPMG Partners notifying them of newly developed Tax Solutions.
Toolkit	The package of specific tools/templates developed by a Development Team for use by a Deployment Team in presenting and implementing a Tax Solution.
Toolkit Item	An individual tool (<i>e.g.</i> , an engagement letter) included as part of a Toolkit.

3374

White Paper

Main deliverable from Tax Solution technical development, which should thoroughly research, and document the tax technical and non-tax issues associated with the Tax Solution and resolve all such matters.

December 31, 1999

«M_1Investor»
«M_36Corp»
«M_37Trust»
«M_2Investor_Address»
«M_38Street»
«M_39City»

You have requested our opinion regarding the U.S. federal income tax consequences of certain investment transactions that have been concluded by «M_1Investor» ("Investor"), a Delaware single-member limited liability company. As more fully described below, Investor participated in a series of transactions involving investments in foreign currency-based securities and derivative contracts through an investment fund. The investment transactions were structured through an investment program (the "Investment Fund") designed by Presidio Growth LLC ("Presidio"). Presidio is an independent investment advisor registered under the Investment Advisers Act of 1940 that specializes in structured financial products and the execution of associated investment and derivative-based trading strategies.

Presidio acted as investment advisor and managing member (the "Managing Member") with respect to Investor's participation in the Investment Fund. Prior to its entry into the Investment Fund, Presidio provided to Investor the attached Strategic Investment Fund Confidential Memorandum that sets forth the potential financial returns and risks from participation in the investment program. Based upon Investor's independent assessment of the Strategic Investment Fund Confidential Memorandum, Investor has represented that Investor believed that there was a reasonable expectation of earning a reasonable pre-tax profit from the investment transactions described that would be in excess of all associated fees and costs, without regard to any tax benefits that might occur.

Our opinion and supporting analysis are based upon the following description of the facts and representations associated with the investment transactions undertaken by Investor. In rendering our opinion, we have reviewed the applicable provisions of the Internal Revenue Code of 1986, as amended ("Code"), and the final, temporary, and proposed Treasury Regulations (hereinafter "Treas. Reg." or "regulations") promulgated thereunder; relevant decisions of the U.S. federal courts; published Revenue Rulings

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 84

KPMG 0000405

Page 2
 «M_Investor»
 December 31, 1999

("Rev. Rul.") and Revenue Procedures ("Rev. Proc.") of the Internal Revenue Service ("Service") and other materials as we have considered relevant.¹

Our opinion is limited to the conclusions expressed below in the sections entitled "*Summary of Opinion*" and "*Conclusion*." In various sections of the opinion, for ease of understanding and as a stylistic matter, we may use language such as "will" or "should" which could suggest that we reached a conclusion on an issue at a standard different from "more likely than not."² Such language should not be so construed. Our conclusions on any issue discussed in this opinion letter do not exceed a "more likely than not" standard.

I. Description of Investment Transactions

A. Overview of Investment Program

The following describes the investment program entered into by Investor and the investment structure utilized based upon information provided to us by Presidio. A more detailed explanation of the underlying investment strategy devised by Presidio is contained in the attached Strategic Investment Fund Confidential Memorandum.

Presidio has represented the following relative to the investment program entered into by Investor:

Since inception of floating exchange rates in 1973, all currencies have been subject to wide swings in value. The general consensus by the international financial community is that exchange rate volatility is undesirable because of the adverse impact these swings have on international capital flows. Consequently, many governments influence the level of their currency by intervening in foreign exchange markets. Emerging market governments are typically more active participants in

¹ Code Section 6110(j)(3) provides that a written determination, (e.g., a private ruling, determination letter, or technical advice memorandum), may not be used or cited as precedent. However, in Xerox Corp. v. U.S., 656 F.2d 659, 660 (Cl. Ct. 1981), the court noted that although private letter rulings have no precedential value, "they are helpful, in general, in ascertaining the scope of the...doctrine adopted by the Service and in showing that the doctrine has been regularly considered and applied by the Service."

² Under a "more likely than not" standard, we are of the opinion that under current U.S. federal income tax law there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the positions taken will be upheld if challenged by the Internal Revenue Service.

Page 3
«M_1Investor»
December 31, 1999

their respective currency markets because emerging market currency levels are more easily controlled and the benefits to the emerging market nations are more significant. By controlling the level of their currency, emerging market nations encouraged capital inflows by mitigating the risk of currency devaluation. In addition, by entering into a managed currency regime, the emerging market nation can curb hyperinflation, a problem faced by many emerging market nations due to a combination of rapid growth and imprudent fiscal management common to many of these countries.

The Investment Fund entered into by Investor was established by Presidio as an investment that sought to provide investors with a high total return. To obtain this objective, the Investment Fund invested in U.S. dollar and foreign currency denominated debt securities of corporate and governmental issuers and entered into forward foreign currency contracts, options on currencies and securities and other investments selected by Presidio, as Managing Member of the Investment Fund.³

It was Presidio's belief that successful implementation of its investment strategy could best be achieved through a relatively long-term investment horizon. Accordingly, the Investment Fund was structured as a three stage, seven year investment program. The core investment strategy underlying all three stages was to maintain long or short positions in debt securities and currency exchange contracts. Through such investments, the Investment Fund sought to profit from changes that Presidio anticipated would occur in the value of the currencies in which such securities were denominated or quoted or to which the forward currency exchange contracts related.⁴

³ An investment in the Investment Fund increased or declined in value as a result of changes in the value of the securities in which the Investment Fund invested and the currencies and securities underlying the forward foreign currency contracts and options.

⁴ These profit opportunities were primarily based upon selectively selling ("shorting") overvalued emerging market currencies and selectively buying ("going long") undervalued emerging market currencies. The investment strategy effectively sought to obtain high risk-adjusted returns for its investors by exploiting opportunities to short currencies under unsustainable managed currency regimes and going long currencies previously subject to managed currency regimes that were considered fundamentally undervalued by Presidio due to political or economic upheaval. By monitoring the economic conditions in

The three investment stages were differentiated by the degree of risk assumed by the Investment Fund. In each successive stage, Presidio was to allocate a greater percentage of the Investment Fund's assets to securities and currency positions that allowed a greater opportunity for profit but also correspondingly greater risk. Reflecting the greater degree of risk, Presidio could require investors to make additional capital contributions. However, the aggregate contributions of an investor could not exceed the amount to which such investor agreed at the time of subscription to the Investment Fund. The obligation to make additional capital contributions terminated if the investor notified Presidio of its election to withdraw its entire capital account balance from the Investment Fund.

The anticipated time horizons and associated investment strategies for the three stages at the time Investor entered into the Investment Fund were as follows:

- Stage I: The first stage was expected to last 60 days, during which time the Investment Fund would engage in strategies that the Managing Member believed entailed relatively low levels of risk compared to later investment stages. An example of a strategy that could be used during this stage was for the Investment Fund to sell short currencies under managed currency regimes ("pegged currencies") that the Managing Member believed were likely to depreciate in the short term.
- Stage II: The second stage of the investment strategy was expected to last approximately 120 days. During stage two, the Investment Fund would pursue similar investment strategies as during stage one. However, the degree of risk taken by the Investment Fund would increase. More of the Investment Fund's capital was to be allocated to riskier positions, resulting in higher potential profit but also higher potential losses and volatility. Due to the increase in risk during

emerging market countries and the direction of the currency markets, Presidio sought to identify, and profit from, those currency devaluations which were most likely to occur over the life of the Investment Fund.

investment stage two, the members could be required to increase their capital contributions to the Investment Fund.

- Stage III: The third stage of the investment strategy was expected to last approximately 6.5 years. During the third investment stage, the Investment Fund would pursue investment strategies that had the potential for greater rewards but also would entail substantially greater risk. For example, in addition to maintaining short positions in pegged currencies which the Managing Member believed to be overvalued, the Investment Fund could establish long positions in emerging market currencies that have recently been devalued. By buying debt securities denominated in recently devalued currencies or entering into forward currency exchange contracts after a devaluation, the risk profile of the Investment Fund would be higher than during the first two stages; however, the potential returns were expected to be commensurately higher.⁵

The minimum investment for an investor in the Investment Fund was \$10 million in return for a Class A interest. Contributions to the Investment Fund had to be in cash. At the discretion of Presidio, as the Managing Member, the Investment Fund allowed a Class A Member to contribute cash subject to indebtedness at the time of subscription. If an investor funded its investment capital through a loan, the Managing Member required investors to arrange at least seven-year financing in order to cover the expected term of the program.⁶ In addition to one or more Class A Members and the Managing Member, the Investment Fund allowed for one or more holders of Class B interests. The Class B Member(s) were affiliates of the Managing Member.

Class A Members had the right to withdraw all (but not part) of their capital account balances upon written request to the Managing Member beginning on the 60th day following the Class A Member's initial investment and each 60 day

⁵ Presidio believed that currencies which had recently been devalued typically were undervalued due to economic upheaval and abnormally high interest rates. The value of these currencies may, however, be particularly volatile.

⁶ Presidio effectively allowed an investor a choice of funding its participation in the Investment Fund on either a non-leveraged basis or a leveraged basis by contributing cash subject to an outstanding loan to the Investment Fund.

Page 6
 «M_1Investor»
 December 31, 1999

anniversary thereafter provided that the Managing Member received the written request at least 10 business days prior to such date. Unless the Managing Member otherwise agreed, Class B Members could only withdraw their capital account balances following the withdrawal by all of the Class A Members. In lieu of accepting a Class A Member's withdrawal request, the Managing Member could have elected either to liquidate the Investment Fund or to arrange for the purchase of the Class A Member's interest at a price equal to the withdrawal proceeds that the Class A Member would otherwise have received.

B. The Investment Structure

On «M_3Loan_Date» Investor obtained a «M_4Loan_Amount» fixed rate nonrecourse loan⁷ from «M_5Bank». Under the terms of the credit agreement (the "Credit Agreement")⁸ between «M_5Bank» and Investor, the «M_4Loan_Amount» principal amount of the loan was payable on the seventh anniversary of the borrowing date.⁹ Interest on the loan was payable quarterly at a rate of «M_6Loan_Annual_Interest_Rate» percent per annum. The loan proceeds were initially transferred to Investor's personal bank account at «M_5Bank» and then immediately transferred to Investor's trading account at «M_5Bank».

Presidio has represented to us that Investor opted to repay the loan at a «M_6Loan_Annual_Interest_Rate» percent interest rate in return for a premium payment of «M_7Premium» in order to lessen the financial risks associated with participation in the Investment Fund. As discussed, the Investment Fund uses a three stage approach with increasing levels of investment risk in each subsequent stage. Presidio further represented to us that Investor entered into a financing arrangement whereby higher levels of financing risks were incurred early in the program, with such risks declining as the loan premium amount was amortized over the term of the loan. According to Presidio, the structure of Investor's loan results in an integrated investment strategy whereby there are complementary levels of investment risks and financing risks at all

⁷ Section 9.14 of the Credit Agreement states that «M_5Bank» agrees and acknowledges that neither it (nor any of its affiliates) shall have any recourse against the Investor or any of its assets or property other than the pledged collateral.

⁸ Any future references to the Credit Agreement incorporating terms defined within the Credit Agreement will use the convention of capitalizing such terms.

⁹ Under the terms of the Credit Agreement (Section 3.01), Investor had the ability to prepay the loan subject to any applicable prepayment penalties and breakage fees. Pursuant to Section 3.02 of the Credit Agreement, the amount of any prepayment penalty is a function of interest rates at the time of prepayment.

Page 7
 «M_Investor»
 December 31, 1999

times during the term of the Investment Fund. By having the loan premium structure, it is the view of Presidio that it is possible to match investment risks with financing risks.¹⁰

The investment program entered into by Investor was structured through «M_10Fund_Name», a Delaware limited liability company ("Partnership") that was treated as a partnership for U.S. federal income tax purposes.¹¹ Presidio, through two limited liability companies, contributed «M_8Presidio_Contribution» to Partnership for a 1% interest as Managing Member and a 9% Class B interest.¹² Investor contributed «M_9Cls_A_Contribution»¹³ subject to the «M_4Loan_Amount» nonrecourse loan to Partnership for a 90 percent Class A interest on «M_11Contribution_Date».¹⁴ The assumption of the loan by Partnership was approved by «M_5Bank» pursuant to the Assignment and Assumption Agreement dated «M_11Contribution_Date». To mitigate its risk position with respect to interest rate changes during the term of the loan, Partnership entered into a fixed-for-floating rate interest rate swap with «M_5Bank» for a term of approximately seven years.¹⁵

¹⁰ Presidio has represented to us that over the seven-year term of the loan, an investor would be exposed to several types of financial risks resulting from potential changes in interest rates. Of particular concern to an investor is residual interest rate risk (the "convexity" effect). According to Presidio, Investor has managed residual interest rate risk through the structuring of a financing package with a loan premium as its integral economic component. See the attached discussion of the underlying financial theory in the "Analysis of Financing Alternatives" prepared by Presidio. In the analysis, Presidio recommends the use of the loan premium structure to mitigate residual interest rate risk.

¹¹ A limited liability company with multiple members can elect to be classified as a partnership or as an association taxable as a corporation. Absent an election, a domestic multi-member limited liability company will automatically be classified as a partnership pursuant to Treas. Reg. Sec. 301.7701-3(b)(1)(i).

¹² Presidio Growth LLC was the Managing Member with a 1% interest in Partnership and Presidio Resources LLC had the 9% interest.

¹³ The capital contribution stated in this opinion letter does not reflect a de minimis amount of accrued interest earned by Investor during the period between the time of entering into the loan and the contribution of the proceeds to Partnership. Accordingly, future references in this Opinion to the capital contribution by Investor and Investor's adjusted basis in Partnership or any distributed asset do not reflect such accrued interest. Such references are merely made to illustrate the operation of applicable tax laws to Investor's transactions, and do not imply that we are opining on the precise amount of Investor's capital contribution or adjusted basis.

¹⁴ «M_5Bank» represented to us that there was no plan or intention to require Investor to convey the loan proceeds or assign the loan obligation to Partnership.

¹⁵ Partnership entered into the fixed-to-floating rate swap to hedge interest duration risk. Duration risk (or more precisely "modified" duration) is a measure of the price sensitivity of a bond to interest rate movements. It is used to measure the sensitivity of a bond's price (i.e., the present value of its cash flows) to interest rate movements. A swap from fixed-to-floating can be used to hedge interest rate duration risk.

Page 8
 «M_1Investor»
 December 31, 1999

The Limited Liability Company Agreement of the Partnership required that capital accounts be maintained pursuant to Code Section 704(b) and the Regulations promulgated thereunder. In general, Partnership net profits and losses were allocated among the Members as follows: 90% to the Class A Members, 9% to the Class B Members and 1% to the Managing Member except for a management fee, which was allocated to the Class A and Class B Members on the basis of their capital account balances. The Class B Members were entitled to a preferred return equal to 12% per year (or any portion thereof) of their capital account balances before any allocation of profit was made to the Class A Members or the Managing Member.

C. Subsequent Events and Investment Results

On «M_12TerminationLiquidation_Date», upon completion of Stage I of the Investment Fund, Investor opted to terminate its participation in the Investment Fund. As a result of Investor not opting to participate in Stage II of the Investment Fund, Investor elected to have its Partnership interest redeemed. On «M_12TerminationLiquidation_Date», Partnership redeemed Investor's Partnership interest for «M_17Cash_Distributed» cash.

Subsequent to Investor's withdrawal from Partnership, Partnership continued making investments with the remaining partnership assets utilizing the «M_4Loan_Amount» loan for financing. The covenants contained in the Credit Agreement allowed «M_5Bank» to call the «M_4Loan_Amount» loan if the Investor ceased to own directly or indirectly at least a majority of the outstanding membership units in Partnership (an "Event of Default") upon giving written notice to Partnership.

II. Representations

A. Representations Made to KPMG by Investor

In connection with the transactions described above, Investor has represented to KPMG LLP ("KPMG") the following:

- Investor's single member invests directly in marketable securities and other financial instruments on «M_29Gender» own account.

See attached discussion of the underlying financial theory in the "Analysis of Financing Alternatives" prepared by Presidio.

Proprietary Material
 Confidentiality Requested

KPMG 0000412

Page 9
«M_1Investor»
December 31, 1999

- Investor acted independently of, and at arm's length from, the Managing Member, the Class B Member and «M_5Bank» with respect to the transactions described herein.
- There was no legally binding agreement, written or otherwise, that compelled Investor to complete the transactions in the way described herein. The duration of Investor's participation in the Investment Fund was dependent upon the performance of the program relative to alternative investments.
- There were no written agency agreements or arrangements (apart from Presidio's role as Managing Member of Partnership) consummated with respect to the transactions undertaken pursuant to the Investment Fund and neither Investor, nor to the best of Investor's knowledge, any parties involved held themselves out to a third party as agents of any of the others with respect to these transactions.
- Investor independently reviewed the economics underlying the Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions described herein (not including any tax benefits that may occur), in excess of all associated fees and costs.
- Investor has provided KPMG with all facts and circumstances that Investor knows, or has reason to know, are pertinent to this opinion letter and believes that all its representations on which this opinion relies are reasonable.
- Investor and Investor's sole member each use the U.S. dollar as its functional currency.
- The capital contribution, made by Investor's sole member, was made from Investor's sole member's separate property.

B. Representations Made to KPMG by Presidio

In connection with the transactions described above, Presidio has represented to KPMG the following:

Proprietary Material
Confidentiality Requested

KPMG 0000413

Page 10
 «M_Investor»
 December 31, 1999

- Presidio believed there was a reasonable opportunity for Investor to earn a reasonable pre-tax profit, in excess of all associated fees and costs, and without regard to any tax benefits that may occur, by participating in the Investment Fund. Presidio communicated this belief to Investor.
- Presidio acted independently of, and at arm's length from, Investor and «M_5Bank» with respect to the transactions described herein.
- «M_5Bank» did not, directly or indirectly, control or participate in the management or operations of Partnership.
- «M_5Bank» did not, directly or indirectly, control or direct the investments of Partnership apart from its rights under a Pledge and Security Agreement, Credit Agreement, and Account Control Agreement.
- All of Partnership's foreign currency transactions were conducted over the counter. Therefore, Partnership did not undertake transactions on a national securities exchange registered with the Securities and Exchange Commission. Furthermore, Partnership did not undertake transactions on a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission.
- There did not exist at the time Investor or any assignee entered into trading strategies, within the range of Permitted Investments, an Event of Default under the terms of the Credit Agreement.
- Neither the Investor nor any assignee entered into trading strategies, within the range of Permitted Investments, in a manner that results in or causes an Event of Default under the terms of the Credit Agreement.
- The loan collateral and covenants were not altered or amended upon assumption of the loan by Partnership.
- The descriptions of the Investment Fund and the economics of the financing arrangement used by Investor, as set forth in the Overview of Investment Program and The Investment Structure sections of this opinion letter, and in the attachments hereto, are accurate.

Proprietary Material
 Confidentiality Requested

KPMG 0000414

Page 11
 «M_1Investor»
 December 31, 1999

- Any amount due under the Note, other than the aggregate outstanding principal amount, any accrued but unpaid interest, and the unamortized premium is expected to be incidental (i.e., under all reasonably expected market conditions on the date of issuance of the Note, the potential amount of any such payment would be insignificant relative to the total expected amount of the remaining payments on the Note).

C. Representations Made to KPMG by «M_5Bank»

In connection with the transactions described above, and in addition to any representations described in any other section of this opinion letter, «M_5Bank» has represented to KPMG the following:

- The loan made pursuant to the Credit Agreement was approved by the competent authorities within «M_5Bank» as consistent, in the light of all the circumstances such authorities consider relevant, with «M_5Bank» credit and documentation standards.
- «M_5Bank» acted independently of, and at arm's length from, Investor and the other participants in the Investment Program.
- «M_5Bank» recorded for U.S. GAAP accounting purposes and U.S. regulatory purposes the Stated Principal Amount and the Initial Unamortized Premium Amount of the loan made pursuant to the Credit Agreement as follows: a «M_4Loan_Amount», seven-year loan and a «M_7Premium» unamortized premium amount, respectively.
- The Credit Agreement provides that the Maturity Date of the loan made thereunder is the seventh anniversary of the applicable Borrowing Date. Furthermore, Section 8 of the Credit Agreement sets forth the conditions upon which the principal of and any accrued interest in respect of the applicable Note, the applicable Prepayment Amount, if any, the applicable Breakage Fee, if any, and all other obligations owing under such Credit Agreement and the applicable Note may be declared to be, or become, due and payable prior to the applicable Maturity Date. Except as provided in such Credit Agreement, «M_5Bank» would not accelerate any stated principal or interest payment due under the Credit Agreement.

Proprietary Material
 Confidentiality Requested

KPMG 0000415

Page 14
 «M_1Investor»
 December 31, 1999

IV. Analysis of Investment Transactions

A. Investor's Receipt of Loan Proceeds

1. Debt Instruments – The General Rules

The value of a debt instrument is equal to the present value of its future cash flows, which consist of interest and principal. The rate used to compute the present value of these cash flows is the interest rate that provides an acceptable return on an investment commensurate with the issuer's risk characteristics (the "market rate of interest"). If the market rate of interest differs from the stated interest rate, the present value of the debt instrument will differ from the face value of the debt instrument. The difference between the face value and the present value of the debt instrument is either a discount or premium. For example, if a debt instrument is issued with a premium, the effective interest rate will be lower than the stated interest rate. In the instant case, the calculation is as follows:

Present value of the principal = principal x discount factor at the market rate of interest

$$\bullet \text{ «M_4Loan_Amount»} \times \text{«M_18PVF_Principal»} = \text{«M_19Amount_A»}$$

Present value of interest payments = the sum of (quarterly payments x appropriate discount factors at the market rate of interest)

$$\bullet \text{ «M_20Annual_payments»} \times \text{appropriate discount factors at the market rate of interest} = \text{«M_22Amount_B»}$$

Present value of debt = Present value of principal + Present value of interest payments

$$\bullet \text{ «M_19Amount_A»} + \text{«M_22Amount_B»} = \text{«M_23PV_of_Debt»}$$

From a financial accounting perspective, a debt instrument must be recorded at its present value to properly measure the associated interest expense for financial statement purposes. The resulting «M_7Premium» premium in the above example is not a liability because it does not result in any future net economic loss to the issuer. The lower

Page 15
 «M_1Investor»
 December 31, 1999

effective rate of interest merely results because the proceeds from the borrowing exceed the face or maturity amount of the debt. The same logic would apply to a discount. A discount on a debt instrument does not represent prepaid interest and is not an asset for financial accounting purposes. Such amount is not an asset because it does not provide any future economic benefit. A loan discount or premium is not an asset or liability separate from the note giving rise to it, but is reported as a direct deduction from, or addition to, the face amount of the loan for financial accounting purposes. Conceptually, a premium on debt payable is a liability valuation account that has no existence apart from the related debt. For financial accounting purposes, based upon U.S. generally accepted accounting principles, the premium account is referred to as an adjunct account.¹⁷

The "OID rules" were introduced to conform the Code provisions relating to the measurement and timing of interest with the methods developed in the financial marketplace and applied under generally accepted accounting principles. OID stands for original issue discount, and generally refers to the tax accounting methods developed since 1982 for the measurement and timing of interest income and expense arising with respect to debt instruments. The Code and Regulations refer to all forms of indebtedness as "debt instruments." The term "bond" has the same meaning as the term "debt instrument" in Treas. Reg. Section 1.1275-1(d).¹⁸ Thus, the terms will be used interchangeably for purposes of this opinion.

Under the OID rules, a debt instrument issued with a stated interest rate in excess of prevailing market rates for instruments of the same credit quality and maturity results in receipt of a bond premium to the issuer. Bond premium generally can be viewed as the mirror image of OID. From an income tax perspective, amortization of a premium results in the proper timing of recognizing interest income on the part of the holder and deducting interest expense on the part of the issuer of a debt instrument. Thus, for OID purposes, consistent with the financial accounting rules, the amount of premium is not considered a liability separate from the debt instrument that gave rise to it.

As further discussed herein and consistent with financial accounting rules, the amount of loan premium for tax purposes is calculated by subtracting from the loan's issue price all amounts payable under the debt instrument other than stated interest. In the instant case, Investor borrowed «M_4Loan_Amount». The «M_4Loan_Amount» loan is due on the

¹⁷ Opinions of the Accounting Principles Board No. 21 (New York: AICPA, 1971).

¹⁸ Treas. Reg. Section 1.171-1(b)(1).

Page 16
 «M_1Investor»
 December 31, 1999

seventh anniversary of the borrowing date and bears interest payable quarterly at an annual interest rate of «M_6Loan_Annual_Interest_Rate» percent. The present value and issue price of the loan is «M_24Loan_Premium». Subtracting the «M_4Loan_Amount» face amount from the loan's «M_24Loan_Premium» issue price results in a loan premium of «M_7Premium». The loan premium is not an additional liability, but is reported as a separate item for the purpose of properly measuring interest consistent with both the financial accounting rules and the OID provisions. The premium is effectively a valuation account that is an addition to the «M_4Loan_Amount» face amount of the loan giving rise to it.

Bond issuance premium is the excess of a debt instrument's issue price over its stated redemption price at maturity ("SRPM"). Code Section 1273(a)(2) defines SRPM to include all amounts payable under the debt instrument (other than interest based on a fixed rate or an objective interest index, and payable unconditionally at fixed intervals of one year or less during the entire term of the debt instrument).

Under Code Sections 1273(b)(1) - (5) and 1274, the issue price of a debt instrument depends on the circumstances surrounding its issuance. The following general rules apply:

- For publicly offered debt instruments not issued for property, the issue price is the initial offering price at which a substantial amount of the debt was sold.
- For debt instruments issued for property when either the debt or the property is publicly traded, the issue price is the fair market value of the property.
- For debt instruments issued for property when neither the debt nor the property is publicly traded, the issue price under Code Section 1274 is the stated principal amount of the debt, or a lower imputed amount.
- For other debt instruments not issued for property, including those issued in a bank's lending transactions, the issue price under Code Section 1273(b)(2) is the amount paid by the first purchaser.
- For transactions not subject to any of the above rules, the issue price generally will be the SRPM.

Proprietary Material
 Confidentiality Requested

KPMG 0000420

Page 17
 «M_1Investor»
 December 31, 1999

For purposes of applying the above rules, the term "property" includes services and the right to use property, but does not include money. In transactions to which Code Section 1273(b)(2) applies, a payment from the borrower to the lender (other than a payment for property or for services provided by the lender such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. Solely for purposes of determining the tax consequences to the borrower, the issue price is not reduced if the payment is deductible under Code Section 461(g)(2).¹⁹ Thus, the bond issuance premium is «M_7Premium», measured by the excess of the obligation's issue price under Code Section 1273(b)(2) of «M_24Loan___Premium» over the SRPM of «M_4Loan_Amount».

Under Treas. Reg. Section 1.163-13, the issuer amortizes bond issuance premium by offsetting the qualified stated interest²⁰ allocable to an accrual period²¹ with the bond issuance premium. Thus, the interest deduction otherwise allowable under Code Section 163 is reduced by the amount of bond issuance premium allocable to the period. The interest deduction amount and amortization of bond issuance premium are determined on a constant yield method and accrue ratably within an accrual period. The amount of bond issuance premium allocable to an accrual period is the product of the debt instrument's adjusted issue price²² at the beginning of each period and its yield to maturity²³ as adjusted to reflect the length of the period. In the instant case, the loan premium will be amortized ratably as an offset to Investor's and Partnership's interest expense deductions for each accrual period.²⁴

Under Treas. Reg. Section 1.61-12(c), prior to amendment by the final regulations, the issuer of a premium debt instrument took the premium into account as a separate item of income over the life of the debt instrument and interest payable was also a separate deductible item. Treas. Reg. Section 1.163-13 clarifies that the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. This change effectively makes the tax

¹⁹ Treas. Reg. Section 1.1273-2(g)(2).

²⁰ As defined in Treas. Reg. Section 1.1273-1(c).

²¹ Treas. Reg. Section 1.446-2(b) determines the accrual period to which qualified stated interest is allocable and the qualified stated interest allocable to an accrual period.

²² Determined under Treas. Reg. Section 1.1275-1(b).

²³ Determined under Treas. Reg. Section 1.1272-1(b)(1)(i).

²⁴ With respect to Partnership's assumption of the nonrecourse loan, the terms "issuer" and "obligor" are interchangeable and refer to the issuer of a debt instrument or a successor obligor. Treas. Reg. Section 1.1001-3(f)(5)(i).

Page 18
 «M_1Investor»
 December 31, 1999

accounting rules consistent with the financial accounting rules by recognizing that premium and discounts are merely valuation accounts, not discrete liabilities or assets.

Under Treas. Reg. Section 1.61-12(c)(1), an issuer does not recognize gain or loss upon the issuance of a debt instrument. Accordingly, we are of the opinion that it is more likely than not that Investor will recognize no gain or loss upon receipt of the loan proceeds of «M_4Loan_Amount», including the loan premium of «M_7Premium».

2. Investor as the True Borrower

Investor entered into the «M_4Loan_Amount» loan on «M_3Loan_Date» and Investor then contributed «M_9Cls_A_Contribution» subject to the «M_4Loan_Amount» loan to Partnership for a 90 percent interest on «M_11Contribution_Date». Upon the contribution, the loan was assumed by Partnership. The loan was entered into by Investor in contemplation of participating in the Investment Fund. Thus, the issue arises as to whether Investor is the true borrower of the loan proceeds for U.S. income tax purposes. The Service could assert that Partnership should be considered the true borrower based upon an application of the "substance over form" doctrine. A corollary issue is whether Investor should be viewed as having "tax ownership" of the «M_24Loan_Premium» in cash received from the loan.

The question of who is the true borrower arises as a result of Investor's contribution of the loan proceeds to Partnership and Partnership's subsequent assumption of the loan. Investor contributed the proceeds subject to the loan for the business purpose of leveraging its capital contribution. By leveraging its capital contribution outside the Partnership, Investor was able to guarantee a minimum initial amount of financial leverage. This leveraging effect would be particularly important during the first two stages of the Investment Fund where investment returns are premised upon investments in low and moderate risks positions.

In Bolding v. Commissioner,²⁵ the Tax Court found that the taxpayer, and not his wholly owned S corporation, was the true borrower on a line of credit, the proceeds of which taxpayer loaned to his S corporation. Taxpayer's share of flow-through S corporation losses were denied, however, on the basis that the taxpayer was unable to prove that he loaned the proceeds to his S corporation. As a result, the taxpayer was found not to have substantiated sufficient basis in his S corporation stock to deduct the losses.

²⁵ 117 F.3d 270 (5th Cir. 1997).

Page 19
 «M_Investor»
 December 31, 1999

On appeal, the Fifth Circuit agreed with the Tax Court's holding regarding the taxpayer being the true borrower on the line of credit, but found that the Tax Court had erred in concluding the taxpayer could not substantiate his stock basis.

The facts the Fifth Circuit considered in determining that the taxpayer was the true borrower were as follows:

- The promissory note was signed by the taxpayer, as an individual borrower;
- No documents associated with the line of credit were signed by taxpayer in his capacity as "President" of the S corporation;
- The bank did not include the S corporation's tax identification number on the note (a practice it would have followed if the S corporation had been borrower), but included only the taxpayer's social security number;
- The bank testified it intended taxpayer to be the obligor, and it requested financial information only from taxpayer.

Although on appeal the Fifth Circuit ultimately sustained the taxpayer's position, the taxpayer's failure to rigorously respect the form of his loans to the corporation was used against him. Examples of the taxpayer's disregard of proper form included the deposit of loan proceeds from the bank into the S corporation's account, the S corporation's payment of principal and interest directly to the bank, and the taxpayer failing to report interest income on the loan.

There is also a line of cases in which the issue was whether the true borrower was a corporation that, in form, issued a debt instrument to a shareholder of the corporation which guaranteed the debt. The leading case in this area is Plantation Patterns v. Commissioner.²⁶ In Plantation Patterns, the court held that the shareholder-guarantor was the true borrower rather than the corporation for purposes of determining which party was entitled to an interest deduction. The court determined that based on the meager capital position of the nominal borrower, the corporation, the lender was in substance looking to the shareholder-guarantor for payment. As a result, the court

²⁶462 F.2d 712 (5th Cir. 1972).

Page 20
 «M_Investor»
 December 31, 1999

treated the guaranteed debt as an indirect capital contribution to the corporation by the shareholder-guarantor, treating the shareholder-guarantor as, in substance, the true borrower. A key fact in this case was the court's determination that the corporation's assets were wholly inadequate to sustain the debt.

An additional line of cases deal with loans by one party to an intermediary party who re-lends to another party (a so-called back-to-back loan). The principal case is Northern Indiana Public Service Co. v. Commissioner²⁷ where the court held that a finance subsidiary engaged in a back-to-back loan arrangement was not treated as a conduit merely because it was thinly capitalized. Most importantly, the court focused on the fact that the finance subsidiary earned a positive spread on its lending activity. The court also emphasized that the intermediary was not merely transitory and that the intermediary exercised dominion and control over interest proceeds. By contrast, in Aiken Industries, Inc. v. Commissioner,²⁸ the intermediary was a mere conduit because it earned no profit (and, thus, was not respected as the borrower).

The Tax Court looked at the question of whether a taxpayer was a true borrower in determining the deductibility of interest expense in Goodstein v. Commissioner.²⁹ In Goodstein, the court held that the taxpayer's purchase of Treasury notes and a loan to finance the purchase were shams. The facts of the case were that the taxpayer ordered his broker to purchase \$10 million in face value of 1-3/8% Treasury notes. The taxpayer then executed a promissory note with a finance company for \$9.9 million secured by the Treasury notes. The taxpayer directed the finance company to transfer the funds for the promissory note to his broker. Under the agreement with the finance company, the finance company could sell the Treasury notes.

When the broker purchased the Treasury notes for the taxpayer, the finance company did not have sufficient cash to pay the broker, so the finance company had the broker sell the Treasury notes. The Treasury notes were held by the broker for approximately half an hour. The taxpayer issued checks to the finance company for interest on the note; shortly after the finance company received the checks, the finance company loaned the taxpayer an amount equal to the interest paid. On his tax return, the taxpayer deducted the interest paid with the checks as well as the interest on the Treasury notes the finance company credited to his account.

²⁷ 115 F.3d 506 (7th Cir. 1997).

²⁸ 56 TC 925 (1971).

²⁹ 267 F.2d 127 (1st Cir. 1959), *affg.* 30 T.C. 1178 (1958).

Page 21
«M_1Investor»
December 31, 1999

The court determined that no indebtedness existed between the taxpayer and the finance company. The court found that the transitory possession of the Treasury notes was not sufficient to provide substance to the purchase of the Treasury notes or the loan of the funds to purchase the notes. While the court recognized the transactions did create a legal relationship between the taxpayer and the finance company, the relationship was not one of borrower and lender. The court determined the transaction was an exchange of promises for future performances. Because the promissory note lacked substance as indebtedness, the court denied the taxpayer's interest deductions.

The facts in the instant case can be distinguished from the aforementioned cases due to the existence of a business purpose for Investor entering into the loan and the bona fide nature of the debt. Investor was able to effectively guarantee a minimum initial amount of financial leverage by borrowing prior to the contribution to Partnership. In addition, we believe that the bona fide nature of the debt as evidenced by the underlying Credit Agreement and the existence of economic risk and reward with respect to holding the «M_24Loan_Premium» during the «M_35_of_Days» day period between the time of entering into the loan and the contribution of the proceeds to Partnership is a key determinant with respect to Investor being recognized as the true borrower.

The underlying loan documentation clearly establishes that Investor was the true borrower:

- The loan was entered into by Investor in its individual capacity, not as a representative (or member) of Partnership.
- Investor signed the Credit Agreement in its individual capacity.
- The cash proceeds were initially transferred to Investor's personal bank account and then immediately transferred to its securities trading account, not the account of Partnership.

Upon assumption of the loan by Partnership, the Assignment and Assumption Agreement provided that the loan was originally entered into by Investor and assumed by Partnership on «M_11Contribution_Date». The assumption of the loan had to be approved by «M_5Bank» and was subject to a significant number of condition

Page 22
 «M_1Investor»
 December 31, 1999

precedents. «M_5Bank» has represented to us that there was no plan or intention to require Investor to convey the loan proceeds or assign the loan obligation to Partnership.

With respect to economic risk and reward, during the «M_35_of_Days» day period before the cash was contributed to Partnership, Investor had “dominion and control” of the cash proceeds in that Investor could decide how to invest the cash, subject to the loan covenants. In addition, Investor had the economic “benefits and burdens” associated with tax ownership of such proceeds. The income derived from investing the proceeds was income to Investor and the interest associated with carrying the loan was an expense to Investor. Accordingly, we are of the opinion that it is more likely than not that Investor will be recognized as the true borrower of the loan.

3. The Amount of the “Liability” for Code Section 752 Purposes

In 1988, Treasury promulgated Proposed and Temporary Regulations under Code Section 752. In 1991, Treasury issued a new set of Final Regulations under Code Section 752 in an attempt to simplify the rules. While the current Regulations under Code Section 752 do not define the term “liability,”³⁰ the 1988 Regulations defined an “obligation” as a “liability” only to the extent that incurring or holding the obligation gave rise to:

- The creation of, or an increase in, the basis of any property owned by the obligor (including cash attributable to borrowings);
- A deduction that is taken into account in computing the taxable income of the obligor; or
- An expenditure that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital.³¹

The Service’s rulings defining the term “liability” tend to be consistent with the definition in the 1988 Regulations. In Revenue Ruling 88-77,³² the Service ruled that accrued, unpaid expenses and accounts payable of a cash method partnership are not

³⁰ Although Temporary Regulations issued in 1988 provided a definition, the definition was deleted without specific comment in the Final Regulations as part of Treasury’s efforts to simplify the regulations.

³¹ Treas. Reg. Section 1.752-1T(g).

³² 1988-2 C.B. 128.

Page 23
«M_Investor»
December 31, 1999

partnership liabilities. The Service's conclusion was based upon the view that "liabilities" include only those obligations that either create basis (including cash from the borrowings) or give rise to an immediate deduction.

In Revenue Ruling 73-301,³³ the Service ruled that interim payments received by a partnership for services rendered in connection with a long-term contract reported on the completed contract method do not constitute liabilities for purposes of Code Section 752. Instead, the ruling characterizes such payments as "unrealized receivables" within the meaning of Code Section 751(c). The income or loss from performance of the contract would affect the basis of the partnership interests of the partners, as provided for in Code Section 705(a), only when such income or loss is recognized for U.S. income tax purposes. Accordingly, no increase in the adjusted basis of the partnership interests of the partners is made as a result of the receipt by the partnership of the advance payments. The ruling emphasized that the partnership had fully earned the payments and was under no obligation to return them or perform additional services to retain them.

In Helmer v. Commissioner,³⁴ a partnership gave an option on property to a prospective buyer in exchange for consideration. Even though the option resulted in the partnership receiving money (and increasing the basis of its property), without a correlative increase in the partner's bases, the court held that the option agreement did not create a liability because it created no liability on the part of the partnership to repay the funds paid or to perform any services in the future. Accordingly, the obligation to deliver the property upon exercise of the option did not create a liability.

In Revenue Ruling 95-26,³⁵ the Service ruled that a partnership obligation to return securities sold "short" creates a partnership liability for purposes of Code Section 752. The reasoning in the revenue ruling is twofold. First, it maintains that a short sale creates an obligation to return the securities borrowed to effect the sale. However, the ruling cites in support of this proposition Deputy v. du Pont,³⁶ a Supreme Court case that expressly held that a short-sale obligation does not create "indebtedness" for purposes of the interest deduction under the 1928 predecessor of Code Section 163 because "although an indebtedness is an obligation, an obligation is not necessarily an

³³ 1973-2 C.B. 215.

³⁴ 34 T.C.M. (CCH) 727 (1975).

³⁵ 1995-1 C.B. 131.

³⁶ 308 U.S. 488 (1940).

Page 24
 «M_IInvestor»
 December 31, 1999

indebtedness[.]”³⁷ Second, the ruling maintains that the cash proceeds of the short sale create a partnership asset, thereby increasing basis and bringing the obligation within the definition of liability based upon the logic of Revenue Ruling 88-77.³⁸

Revenue Ruling 95-45³⁹ applies a similar analysis to characterize the short-sale obligation of a shareholder who contributes its interest in the sales proceeds, in conjunction with a Code Section 351 incorporation of a going business, as a liability for purposes of Code Section 357 (which treats liabilities transferred in incorporations as taxable “boot” to the extent in excess of the basis of the transferred property) and Code Section 358 (which treats transferred liabilities as money received in calculating the basis of the transferor’s stock). Applying the same reasoning as in Revenue Ruling 95-26, Revenue Ruling 95-45 cites Deputy for the proposition that a short sale creates an obligation to return the borrowed securities. Because that obligation results in an increase in asset basis, the ruling concludes that the obligation constitutes a “liability,” even though acknowledging that the sales proceeds are not currently taxable. In contrast, Revenue Ruling 95-8,⁴⁰ although issued in conjunction with the other two rulings, holds that an exempt organization’s income from a short sale does not result in unrelated business taxable income under Code Section 511 from “debt-financed property” under Code Sections 512(b)(4) and 514(a) and (b). Its rationale is that there is no “acquisition indebtedness” within the meaning of Code Section 514(c) because under Deputy, a short-sale obligation creates an “obligation” but not an “indebtedness.”

The above short-sale revenue rulings collectively hold that the requirement to replace or return the securities borrowed to effect a short sale constitutes an “obligation,” which in turn constitutes a “liability” for purposes of Code Sections 752, 357, and 358, even though not an “indebtedness” for purposes of Code Section 514. These rulings’ rationale seems to be that, because the sales proceeds create basis, they constitute a “liability” even though, as Revenue Ruling 95-45 expressly acknowledges, such proceeds remain untaxed in the recipient’s hands until closure of the sale. The Service’s view in these rulings is that, at the point the obligation is incurred, the amount of the obligation can be determined “with reasonable accuracy.” Accordingly, the “all events” test specified for the accrual of a deduction by Code Section 461(h) and Treas. Reg. Section 1.461-1(a)(2)

³⁷ Deputy, 308 U.S. at 497.

³⁸ An obligation is a liability to the extent that it creates or increases the basis to the partnership of any partnership asset (including cash attributable to borrowings).

³⁹ 1995-1 C.B. 53.

⁴⁰ 1995-1 C.B. 107.

Page 25
 «M_1Investor»
 December 31, 1999

is satisfied.⁴¹ This capacity to measure the amount of the obligation, in turn, supposedly makes the obligation sufficiently "choate" to permit its characterization as a Code Section 752 liability.

The conclusions reached by the Service in these rulings are subject to question because the rulings confuse the sale, which produces the proceeds, with the securities borrowing. Because it is the sale, not the borrowing, that gives rise to the cash and creates additional basis, there is no liability to which Code Section 752 status can attach.⁴²

In the instant case, Investor obtained a «M_4Loan_Amount» loan from «M_5Bank» that included a premium payment of «M_7Premium» in addition to the principal amount of «M_4Loan_Amount». Investor contributed «M_9CIs_A_Contribution» in cash subject to the loan of «M_4Loan_Amount» to Partnership. Investor's basis in its interest in Partnership is a function of the amount of the cash contributed and the treatment of the loan as a liability under Code Section 752. As discussed, a liability for Code Section 752 purposes generally includes any obligation of the partnership or partner to the extent that incurring or holding it results in the creation of, or an increase in, the basis of any property owned by the obligor (including cash); a deduction taken into account in computing taxable income; or a nondeductible, noncapitalizable expenditure.⁴³ In the context of Code Section 752, the OID concepts discussed above are not generally applied (except as discussed below in two defined situations). Accordingly, the amount of the debt assumed is «M_4Loan_Amount», the principal amount of the debt contributed to Partnership, because such amount constitutes the amount of the loan assumed based upon the «M_6Loan_Annual_Interest_Rate» percent coupon rate of interest.

⁴¹ Under the Regulation, the all events test traditionally permitted the accrual of an expense when "all events have occurred which determine the fact of the liability, and the amount of such liability can be determined with reasonable accuracy." See Code Section 461(h)(4) (restating traditional test). Since 1984, however, Code Section 461(h) generally has required that the test not be treated as having been satisfied until the occurrence of economic performance, such as the provision of required goods or services. Pub. L. No. 98-369 section 91(a), 98th Cong., 2d Sess. (1984).

⁴² See McKee, Nelson, and Whitmore, Federal Taxation of Partnerships and Partners, Chapter 7.01, for a further discussion of the inconsistencies contained in these rulings.

⁴³ See the Revenue Rulings discussed above, as well as McKee, Nelson, and Whitmore, Federal Taxation of Partnerships and Partners, Chapter 7. As previously noted, Code Section 752 and the Treasury Regulations thereunder do not define the term "liability."

Page 26
 «M_1Investor»
 December 31, 1999

The application of the time-value-of money concepts in the context of Code Section 752 parallels how the rules are applied for purposes of Code Section 465.⁴⁴ In Follender v. Commissioner,⁴⁵ the Tax Court rejected the Service's position that present value concepts should be imposed on the "at risk" rules under Code Section 465. Based upon the lack of support in the legislative history and the statutory language of Code Section 465, the Tax Court refused to find an "implied limitation of the borrowed amount to present value,"⁴⁶ observing that "Congress has been explicit in the areas it has chosen to require present value calculations."⁴⁷ The court further stated that "the statute does not allow for present value calculation, expressly or implicitly."⁴⁸ In the context of Code Section 752, time-value-of money concepts are applied in two defined situations: (1) a special rule for non-recourse liabilities with interest guaranteed by a partner,⁴⁹ and (2) with respect to an unreasonable delay of a partner's obligation to make payments to the partnership.⁵⁰ Neither fact pattern applies to the instant case. As to the instant case, there is no requirement in the Code or Regulations that a taxpayer apply a present value approach in the context where the applicable interest rate with respect to a debt instrument gives rise to a loan premium amount. Accordingly, the amount of the debt assumed by Partnership is the "face," or principal amount, of «M_4Loan_Amount».

With respect to the interest paid on the loan, all interest paid or accrued within the taxable year on indebtedness is deductible under Code Section 163. A liability (as defined in Treas. Reg. Section 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for U.S. income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with

⁴⁴ See S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.8 (1976).

⁴⁵ 89 T.C. 943 (1987).

⁴⁶ Follender, 89 T.C. at 953.

⁴⁷ Follender, 89 T.C. at 952.

⁴⁸ *Id.*

⁴⁹ Treas. Reg. Section 1.752-2(e) treats a nonrecourse obligation as a recourse obligation if a partner guarantees a substantial portion of the interest that will accrue under the obligation. If the rule applies, the partner that has guaranteed the payment of interest is treated as bearing the economic risk of loss for the partnership liability to the extent of the present value of the guaranteed future interest payments.

⁵⁰ Treas. Reg. Section 1.752-2(g) provides that if a partner's obligation to make a payment or contribution is unreasonably delayed, the obligation is adjusted to reflect the time value of money of the deferral. The result of failing to satisfy an obligation on a "timely" basis is to effectively cause the obligation to be valued at less than its "face" amount. If an obligation does not bear interest at a rate at least equal to the applicable federal rate at the time of valuation, the value of the obligation is the discounted present value of all payments due from the partner.

Page 27
 «M_1Investor»
 December 31, 1999

respect to the liability.⁵¹ Treas. Reg. Section 1.461-4(e) provides that economic performance with respect to interest occurs as the interest cost economically accrues in accordance with the principles of the relevant provisions of the Code. This is consistent with the approach taken by the Service in Revenue Ruling 83-84⁵² dealing with the continuing viability of the “Rule of 78’s” method. In the ruling, the Service stated that “no deduction will be allowed to the extent that the debtor’s liability or payment is for interest that does not economically accrue in the current year.” Accordingly, interest payable on the loan would constitute a liability to Partnership in the year payable. The accrued interest payable as a Code Section 752 liability will increase Investor’s basis in Partnership upon accrual and there will be a corresponding decrease in basis under Code Section 705 when the interest is paid.

Based on its reasoning in the short sale rulings that the amount of the Code Section 752 liability is a function of the amount of basis resulting from the short sale, the Service could argue that the amount of the liability, for Code Section 752 purposes, is «M_24Loan_Premium» because the «M_4Loan_Amount» loan gave rise to «M_24Loan_Premium» in Partnership assets. Such position by the Service would be inconsistent with the logic that a liability is not recognized for purposes of Code Section 752 until such time as the all events and economic performance rules are satisfied pursuant to the regulations under Code Section 461.

In the instant case, the «M_7Premium» incremental amount that relates to the premium is repayable through interest payments. In the event of early repayment, a prepayment penalty could arise that is determined based upon prevailing economic factors, primarily then existing interest rates. Accordingly, the all events and economic performance rules are not satisfied upon the Investor’s contribution of the cash subject to the loan.⁵³ To the extent there is a prepayment penalty, it is effectively contingent at the time the loan is contributed to Partnership because the cost of repaying the loan cannot be determined with reasonable accuracy. In *LaRue v. Commissioner*,⁵⁴ the Tax Court held that an obligation is not incurred and taken into account by an accrual basis taxpayer until the year in which all events have occurred to fix the amount of the obligation and economic

⁵¹ Treas. Reg. Section 1.461-1(a)(2).

⁵² 1983-1 C.B.97.

⁵³ The all events and economic performance rules were not satisfied during the term of Investor’s participation in Partnership. The «M_4Loan_Amount» loan remained outstanding after Investor terminated its interest in Partnership.

⁵⁴ 90 T.C. 465 (1988).

Proprietary Material
 Confidentiality Requested

KPMG 0000431

Page 28
 «M_1Investor»
 December 31, 1999

performance has occurred with respect to the obligation. The Tax Court in LaRue relied on Long v. Commissioner,⁵⁵ for its conclusion that contingent liabilities could not be included in a partner's basis until such time as those liabilities are made definite or fixed. Accordingly, we are of the opinion that it is more likely than not that the face amount of the loan, «M_4Loan_Amount», should constitute the amount of the "liability" for purposes of Code Section 752.

B. Investor's Capital Contribution to Partnership

1. Entity Classification as a Partnership

Treas. Reg. Section 301.7701-2(b) describes certain entities that are classified as *per se* corporations for U.S. income tax purposes. None of the categories of entities defined in the Regulations as *per se* corporations would apply to Partnership. Treas. Reg. Section 301.7701-3 provides that an entity not described in Treas. Reg. Sections 301.7701-2(b)(1), (3), (4), (5), (6), (7) or (8) is considered an "eligible entity," which may elect to be classified as a corporation or, if it has 2 or more members, a partnership. Treas. Reg. Section 301.7701-3(b)(1) provides that a domestic eligible entity that has two or more members and does not choose to elect to be classified as a corporation will be classified as a partnership for U.S. income tax purposes.

Based on the facts set forth, Partnership will constitute a domestic eligible entity. Consequently, because an affirmative election to be treated as a corporation was not made, we are of the opinion that it is more likely than not that Partnership will be classified as a partnership for U.S. income tax purposes.

2. Investor's Capital Contribution - The General Rules

The Limited Liability Company Agreement provides that the members' respective capital accounts are maintained based upon the capital account maintenance rules of Code Section 704. The regulations under Code Section 704(b)⁵⁶ provide that a partner's capital account must be credited with the following:

- The amount of money the partner contributes to the partnership.

⁵⁵ 1 T.C. 1 (1978).

⁵⁶ See Treas. Reg. Section 1.704-1(b)(2)(iv)(b) for the basic rules associated with maintaining capital accounts.

Page 29
 «M_1Investor»
 December 31, 1999

- The fair market value of property the partner contributes to the partnership net of any liabilities secured by such property that the partnership is considered to assume or to which the property remains subject to in the partnership's hands.⁵⁷
- Allocations to the partner of partnership income and gain, including income and gain exempt from taxation.

A partner's capital account is decreased by the following:

- The money distributed to the partner by the partnership.
- The fair market value of property distributed to the partner by the partnership net of liabilities that the partner is considered to assume or to which the property remains subject to in the partner's hands.
- Allocations to the partner of partnership expenditures that are not deductible in computing the partnership's taxable income or not properly chargeable to capital account.
- Allocations to the partner of partnership losses and deductions, including financial losses and deductions, but excluding the nondeductible items immediately above.

Code Section 721(a) provides the general rule that no gain or loss is recognized by a partnership or any of its partners as a result of a contribution of "property" in exchange for an interest in the partnership. Money constitutes "property" for purposes of Code Section 721(a).⁵⁸ Generally, there are three circumstances where the Code Section 721(a) nonrecognition rule would not apply:

- A contributing partner can realize gain on the contribution of property to a partnership if the contributing partner is relieved of liabilities in the transaction in an amount in excess of the basis of that partner's partnership interest. Consequently, if property contributed to a partnership is subject to an encumbrance that is less than

⁵⁷ Unlike the Code Section 721 provisions discussed below which look to the adjusted basis of the property contributed, the Code Section 704 capital account maintenance rules look to the fair market value of the property.

⁵⁸ See Treas. Reg. Section 1.721-1(b)(1) which refers to "contributions of money or other property."

Page 30
 «M_1Investor»
 December 31, 1999

the adjusted basis of the property to the contributing partner, the existence of the encumbrance should not cause the recognition of gain on contribution.

- Code Section 721(a) does not apply to contributions to “investment partnerships” that are considered “investment companies” under Code Section 721(b).
- The contribution must not be part of a “disguised sale” taxable under Code Section 707(a).

None of the above circumstances should be applicable to Investor’s cash contribution of «M_9Cls_A_Contribution» subject to the «M_4Loan_Amount» loan because:

- The amount of the loan assumed by Partnership was less than the amount of cash contributed.
- Under Code Section 721(b), the non-recognition rule of Code Section 721(a) does not apply to gain realized upon a contribution of property to a partnership “investment company.” Generally, this rule applies if the contribution results in diversification of the transferor’s assets. The intent of Code Section 721(b) is to prevent tax-free diversification of securities portfolios. In the instant case, both Investor and Presidio’s LLCs are contributing only cash to Partnership. Accordingly, there is no diversification and Section 721(b) should not apply.
- Under Code Section 707(a)(2)(B), a contribution of property by a partner to a partnership may be recharacterized as a sale if the partnership distributes to the contributing partner cash or other property that is consideration for the contribution. Code Section 707(a)(2)(B), by definition, only applies to transactions deemed to be sales. In the instant case, Investor is contributing cash where there is no inherent gain or loss potential.⁵⁹

Accordingly, based upon the Code Section 721(a) general rule of nonrecognition of gain or loss and the non-application of exceptions to that rule, we are of the opinion that it is more likely than not that Investor will not recognize gain or loss with respect to its contribution of cash subject to the loan to Partnership.

⁵⁹ Treas. Reg. Section 1.707-3(b)(1) specifically excludes money or the obligation to contribute money from the definition of what constitutes “property transferred by a partner.”

3. Investor's Capital Contribution - Code Section 1274

Code Section 1274(c) provides that if any person in connection with the sale or exchange of property assumes any debt instrument, or acquires any property subject to any debt instrument, Code Sections 1274 and 483⁶⁰ do not apply to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the assumption or acquisition. Treas. Reg. Section 1.1274-5(a) further addresses the application of Code Section 1274 to an assumption of a debt instrument. The Regulation states that Code Section 1274 does not apply to a debt instrument if the debt instrument is assumed, or property is taken subject to the debt instrument, in connection with a sale or exchange of property, unless the terms of the debt instrument, as part of the sale or exchange, are modified in a manner that would constitute an exchange under Code Section 1001. The same rule applies under Treas. Reg. Section 1.483-1(d).

The Code Section 1001 Regulations employ a two-step analysis to determine whether there has been a deemed exchange of a debt instrument. Any alteration to the terms of a debt instrument must be first tested to determine if a "modification" of the debt instrument has occurred. If so, the modification must then be tested to determine whether it is "significant." A significant modification results in a deemed exchange of the original debt instrument for a modified instrument. The deemed exchange will be a realization event under Treas. Reg. Section 1.1001-1(a) and could potentially give rise to gain or loss, to cancellation of indebtedness income for the issuer, and/or to a change in accounting for interest on the new instrument.⁶¹

The Treas. Reg. Section 1.1001-3 regulations initially define the term "modification" in an extremely broad, all-encompassing manner. A modification is defined as any alteration, addition, or deletion of a legal right or obligation of the issuer or holder of a debt instrument whether evidenced by an amendment of the instrument, conduct of the parties, or otherwise.⁶² The focal point of the definition is "changes or alterations" to the original debt instrument that were not agreed upon at the time of the instrument's issuance.

⁶⁰ Code Sections 1274 and 483 generally apply to ensure adequate interest is charged and paid on an obligation whenever a sale or exchange of property occurs involving the issuance of a debt instrument.

⁶¹ If an assumption of a debt instrument involves a modification that triggers an exchange under Code Section 1001, Treas. Reg. Section 1.1274-5(b)(1) provides that the modification is treated as a separate transaction taking place immediately before the sale or exchange.

⁶² Treas. Reg. Section 1.1001-3(c).

On the other hand, changes or alterations occurring by operation of the original terms of a debt instrument do not generally result in a modification. Treas. Reg. Section 1.1001-3(c)(1)(ii) provides that an alteration of a legal right or obligation that occurs by operation of the original terms of a debt instrument is not a modification. The Regulations contemplate two scenarios whereby such changes could arise -- an alteration that occurs automatically and an alteration resulting from the exercise of an option provided to an issuer or holder.

An example of an alteration which could occur automatically (and, as a result, would not constitute a modification) is an annual resetting of the interest rate based on the value of an index.⁶³ With respect to collateral, a specified increase in the interest rate if the value of collateral declines from a specified level or alternatively the substitution of collateral to maintain required value thresholds would not constitute modifications if the actions are pursuant to the original terms of the agreement.⁶⁴ Example 2 contained in Treas. Reg. Section 1.1001-3(d) sets forth a fact pattern whereby the original terms of a bond provide that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the value of the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and, as a consequence, does not constitute a modification.

The only exceptions to the general rule that changes or alterations occurring by operation of the terms of a debt instrument do not constitute a modification are set forth in Treas. Reg. Section 1.1001-3(c)(2):

- An alteration that results in a new obligor, the addition or deletion of a co-obligor, or a change to any extent in the recourse nature of a debt instrument.
- An alteration that transforms a debt instrument to an instrument or property right that is not a debt instrument unless pursuant to the holder's option to convert the debt instrument into equity of the issuer.

⁶³ Treas. Reg. Section 1.1001-3(c)(ii).

⁶⁴ Treas. Reg. Sections 1.1001-3(c)(ii) and 1.1001-3(d), Example 2.

Page 33
 «M_Investor»
 December 31, 1999

- An alteration resulting from the exercise of an option to change a term of a debt instrument unless the option is unilateral.⁶⁵

Once it is determined that an alteration constitutes a modification, its significance is tested under the general and specific rules in Treas. Reg. Section 1.1001-3(e). Treas. Reg. Section 1.1001-3(f)(4) provides that each modification is independently tested as to whether such modification constitutes a significant modification.

As discussed, an alteration that results in a new obligor, an addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the debt is treated as a modification, even if allowed by the terms of the original debt instrument.⁶⁶ Accordingly, Partnership's assumption of the nonrecourse liability results in a modification of the debt instrument under Code Section 1001.⁶⁷ However, Treas. Reg. Section 1.1001-3(e)(4)(ii) specifically states that the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.

Apart from the alteration resulting from the substitution of a new obligor upon assumption of the loan by Partnership, no additional alterations occurred during the timeframe in which Investor had an ownership interest in Partnership that were not pursuant to the original terms of the debt agreement or that did not occur pursuant to the exercise of a unilateral option.⁶⁸ Accordingly, there were no modifications as defined in Treas. Reg. Section 1.1001-3(c) that would be deemed significant under Treas. Reg. Section 1.1001-3(e) so as to result in a deemed exchange. For example, in satisfying the collateral requirements under the Credit Agreement, Investor (and subsequently Partnership) was required to enter into investment transactions that constituted Permitted Investments. The Credit Agreement contained alternative categories of investments that

⁶⁵ An option is unilateral only if under the debt instrument's terms or applicable law there is, at the time of exercise, no right of the other party to alter or terminate the instrument or to put it to a person related to the issuer; exercise does not require consent of the other party or any person related to the other party or of a court or arbitrator; and exercise does not require consideration unless on the issue date it is de minimis or an amount specified in the debt instrument or based on a formula that uses objective financial information. Treas. Reg. Section 1.1001-3(c)(2)(iii).

⁶⁶ Treas. Reg. Section 1.1001-3(c)(2)(i).

⁶⁷ Treas. Reg. Section 1.1001-3(f)(5)(i) provides that for purposes of testing whether an assumption is an exchange under Code Section 1001, the terms "issuer" and "obligor" are interchangeable and refer to the issuer of a debt instrument or a successor obligor.

⁶⁸ No additional changes were made to the original terms of the Credit Agreement nor was there any additional alterations described in Treas. Reg. Section 1.1001-3(c)(2).

Page 34
 «M_1Investor»
 December 31, 1999

constituted Permitted Investments. Investor and Partnership had the option to change from a Permitted Investment category to another Permitted Investment category under the terms of the Credit Agreement. Such option was a unilateral option (and, as a consequence, did not result in a modification) because there did not exist a right of the other party to alter or terminate the loan and there was no consent required.⁶⁹

Based upon the foregoing analysis, we are of the opinion that it is more likely than not that Partnership's assumption of Investor's non-recourse debt instrument will not result in application of Code Section 1274 or Code Section 483 since the assumption will not constitute an exchange under Code Section 1001. In addition, we are of the opinion that it is more likely than not that there were no subsequent modifications to the Credit Agreement so as to result in an exchange for purposes of Treas. Reg. Section 1.1001-1(a).

4. Investor's Capital Contribution - Treas. Reg. Section 1.61-12(c)(2)

Treas. Reg. Section 1.61-12(c)(2) provides that an issuer generally does not realize gain or loss upon the "repurchase" of a debt instrument. The term "repurchase" includes the retirement of a debt instrument; the conversion of a debt instrument into stock of the issuer; and the exchange (including an exchange under Code Section 1001) of a newly issued debt instrument for an existing debt instrument.

Investor's contribution of the «M_9Cls_A_Contribution» cash subject to the debt of «M_4Loan_Amount» should not constitute a repurchase of a debt instrument under Treas. Reg. Section 1.61-12(c)(2) for the following reasons:

- The debt instrument has not been retired;
- The debt instrument has not been converted into stock of the issuer; and
- The debt instrument has not been exchanged for purposes of Code Section 1001 (see above discussion related to determination of whether a modification constitutes an exchange).

⁶⁹ Treas. Reg. Section 1.1001-3(c)(3).

Page 35
 «M_1Investor»
 December 31, 1999

Accordingly, we are of the opinion that it is more likely than not that Investor will not recognize income under Treas. Reg. Section 1.61-12(c)(2) upon contribution of the loan proceeds to Partnership.

C. Characterization of Debt Instrument

Investor entered into the «M_4Loan_Amount» loan to partially fund its participation in the Investment Fund. As discussed, the loan was a fixed rate debt instrument with a seven-year term and interest payable quarterly at a rate of «M_6Loan_Annual_Interest_Rate» percent per annum. Investor subsequently contributed the loan proceeds subject to the loan to Partnership. Partnership then entered into a fixed-for-floating rate interest swap for a seven-year term to reduce its risks related to a change in interest rates.

Prior to the release of Treas. Reg. Section 1.1275-6, the integration of a debt instrument and a hedge was permitted only in limited situations,⁷⁰ and generally was considered to be a favorable result by taxpayers and commentators. On June 14, 1996, the Service released Final Regulations concerning debt instruments with original issue discount, contingent payment debt instruments, and the anti-abuse rule for OID.⁷¹ The purpose of the Regulations under Treas. Reg. Section 1.1275-6 was to extend the integration treatment to financial instruments that perfectly hedge a qualifying debt instrument into a synthetic fixed or floating rate obligation. Although the integration rules are taxpayer elective, an anti-abuse rule allows the Service relatively broad powers to force integration.

1. Qualifying Debt Instruments and "Section 1.1275-6 Hedges"

Treas. Reg. Section 1.1275-6(a) applies to either issuers or holders of qualifying debt instruments. This Regulation provides for the integration of a qualifying debt instrument and "Section 1.1275-6 hedges" if certain requirements are met and if the combined cash flows of the components are substantially equivalent to those of a fixed or variable rate debt instrument. The purpose of the Regulations is to "permit a more appropriate determination of the character and timing of income, deductions, gains or losses than would be permitted by separate treatment of the components."⁷²

⁷⁰ Examples included integration under Treas. Reg. Sections 1.988-5, 1.446-4, and 1.1221-2.

⁷¹ T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

⁷² Treas. Reg. Section 1.1275-6(a).

Proprietary Material
 Confidentiality Requested

KPMG 0000439

Page 36
«M_Investor»
December 31, 1999

Treas. Reg. Section 1.1275-6(b)(4) provides that if its provisions apply to a qualifying debt instrument and hedge, the integrated transaction is deemed to create a synthetic debt instrument with the same cash flows as the combined cash flows of the qualifying debt instrument and hedge. This integrated instrument generally is subject to the Treas. Reg. Section 1.1275-6 Regulations rather than the rules to which each component of the transaction would be subject on a separate basis.

Under Treas. Reg. Section 1.1275-6(b), a qualifying debt instrument is any debt instrument other than:

- A tax-exempt obligation as defined in Code Section 1275(a)(3);
- A debt instrument to which Code Section 1272(a)(2)(6) (pertaining to certain interests in or mortgages held by a REMIC, and certain other debt instruments with payments subject to acceleration) applies; or
- A debt instrument that is subject to Treas. Reg. Sections 1.483-4 or 1.1275-4(c) (pertaining to certain contingent payment debt instruments issued for non-publicly traded property).

A Section 1.1275-6 hedge is any financial instrument if the combined cash flows of the financial instrument and the qualifying debt instrument permit the calculation of a yield to maturity under the principles of Code Section 1272, or the right to the combined cash flows would qualify under Treas. Reg. Section 1.1275-5 as a variable-rate debt instrument that pays interest at a floating rate or rates (except for the requirement that the interest payments be stated as interest). A financial instrument can be a Section 1.1275-6 hedge only if it is issued substantially contemporaneously with, and has the same maturity as, the qualifying debt instrument. In addition, a financial instrument that hedges currency risk is not a Section 1.1275-6 hedge.

For purposes of determining what constitutes a Section 1.1275-6 hedge, Treas. Reg. Section 1.1275-6(b)(3) defines a financial instrument as a spot, forward, or futures contract; an option; a notional principal contract; a debt instrument, or a similar instrument, or a combination or series of financial instruments. Stock is not a financial instrument for purposes of this Regulation.

Proprietary Material
Confidentiality Requested

KPMG 0000440

2. Requirements for Integration by Taxpayer

A taxpayer may integrate a qualifying debt instrument and a Treas. Reg. Section 1.1275-6 hedge if the taxpayer meets all of the following requirements provided in Treas. Reg. Sections 1.1275-6(c)(1)(i) through (vii):

- The taxpayer must adequately satisfy the identification requirements of Treas. Reg. Section 1.1275-6(e) by entering and retaining as part of its books and records information related to issuance and acquisition of the qualifying debt instrument and the Section 1.1275-6 hedge;
- None of the parties to the hedge may be related unless the related party uses a mark-to-market tax accounting method;
- Both the qualifying debt instrument and the Section 1.1275-6 hedge are entered into by the same individual, partnership, trust, estate, or corporation;
- If the taxpayer is a foreign person engaged in a U.S. trade or business, all items of income and expense associated with the integrated transaction (other than interest expense subject to Treas. Reg. Section 1.882-5) would, in the absence of the integration rules, be effectively connected income during the synthetic debt instrument's term;
- Within 30 days immediately preceding the issue date of the synthetic debt instrument, the taxpayer did not terminate, or "leg out"⁷³ of, an integrated transaction containing the qualifying debt instrument, any other debt instrument that is part of the same issue, or the Section 1.1275-6 hedge;
- The qualifying debt instrument must be issued on or before, or substantially contemporaneously with, the date of first payment on the Section 1.1275-6 hedge, regardless of whether the payment is made or received by the taxpayer; and
- The taxpayer cannot have entered into a straddle⁷⁴ prior to the issue date of the synthetic debt instrument containing the Section 1.1275-6 hedge or the qualifying debt instrument.

⁷³ "Legging" into and out of integrated transactions is described in Treas. Reg. Sections 1.1275-6(d).

⁷⁴ For this purpose, "straddle" is defined under Code Section 1092(c).

3. Integration by Commissioner

Even if a taxpayer does not integrate a qualifying debt instrument and a Treas. Reg. Section 1.1275-6 hedge, the Commissioner may do so if the combined cash flows on the qualifying debt instrument and financial instrument are substantially the same as the combined cash flows required for the financial instrument to be a Section 1.1275-6 hedge. Treas. Reg. Section 1.1275-6(c)(2) provides that the Commissioner may not integrate a transaction unless the qualifying debt instrument is subject to Treas. Reg. Section 1.1275-4 (related to "contingent payment debt instruments")⁷⁵ or Section 1.1275-5 (related to "variable rate debt instruments") and pays interest at an objective rate. Under Treas. Reg. Section 1.1275-5, a "variable rate debt instrument" is a debt instrument that meets all of the following conditions:

- The issue price of the debt instrument must not exceed the total noncontingent principal payments by more than an amount equal to the lesser of:
 - ⇒ .015 multiplied by the product of the total noncontingent principal payments and the number of complete years to maturity from the issue date, or
 - ⇒ 15 percent of the total noncontingent principal payments.
- The debt instrument must only provide for stated interest (compounded or paid at least annually), at:
 - ⇒ one or more qualified floating rates,
 - ⇒ a single fixed rate and one or more qualified floating rates,
 - ⇒ a single objective rate, or
 - ⇒ a single fixed rate and a single objective rate that is a qualified inverse floating rate.

⁷⁵ A "contingent payment debt instrument" is defined under Treas. Reg. Section 1.1275-4 as any debt instrument that provides for one or more contingent payments.

Page 39
 «M_Investor»
 December 31, 1999

- The debt instrument must provide that a qualified floating rate or objective rate in effect at any time during the term of the instrument is set at a current value of that rate.
- The debt instrument must not provide for any contingent principal payments.

Because, under the facts in the instant case, the qualifying debt instrument is a fixed rate debt instrument, Treas. Reg. Section 1.1275-6(c)(2) does not provide the Commissioner with authority to integrate the loan and interest rate swap. Furthermore, the inability of the Commissioner to integrate a hedge with a fixed rate debt instrument was specified in the preamble to the Final Regulations⁷⁶ concerning the anti-abuse rule for original issue discount, as follows:

Section 1.1275-6 INTEGRATION RULES:

Commentators generally approved of the integration rules in the proposed Regulations, and those rules are adopted with only two significant changes. First, the final Regulations allow (but do not require) the integration of a hedge with a fixed-rate debt instrument. For example, a taxpayer may integrate a fixed-rate debt instrument and a swap into a VRDI. Although the hedging transaction Regulations (Section 1.446-4) cover many of these transactions, the integration rules provide more certain treatment. The final Regulations, however, do not allow the Commissioner to integrate a hedge with either a fixed rate debt instrument or a VRDI that provides for interest at a qualified floating rate. In these cases, treating the hedge and the debt instrument separately is a longstanding rule that generally clearly reflects income.

Based upon the foregoing, we are of the opinion that it is more likely than not that the fixed-rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2).

D. Redemption of Investor's Interest in Partnership

On «M_12TerminationLiquidation_Date», at the end of Stage I of the Investment Fund, Investor opted not to enter into Stage II of the investment program. As a consequence,

⁷⁶ T.D. 8674, 61 Fed. Reg. 30133 (June 14, 1996).

Page 40
 «M_1Investor»
 December 31, 1999

Investor's interest in Partnership was redeemed on «M_12TerminationLiquidation_Date».⁷⁷ Since Investor contributed cash to Partnership, the initial basis to Investor of the partnership interest is the amount of money contributed, «M_9Cls_A_Contribution».⁷⁸ However, Investor contributed the «M_9Cls_A_Contribution» subject to a nonrecourse loan of «M_4Loan_Amount». Code Section 752(b) provides that any decrease in a partner's individual liabilities by reason of assumption by the partnership of such liabilities shall be considered as a distribution of money to the partner by the partnership which, under Code Section 733, reduces the basis of the partner's partnership interest.⁷⁹ The basis of Investor's partnership interest is effectively the amount of the money contributed to the partnership reduced by the net liability relief (the difference between Investor's entire loan liability transferred to the partnership⁸⁰ and Investor's share of the liability as a partner, including Investor's share of liabilities contributed by other partners).⁸¹ Treas. Reg. Section 1.752-3 provides that a partner's share of nonrecourse liabilities equals the sum of: (1) the partner's share of the partnership's Code Section 704(b) taxable gain; (2) the partner's Code Section 704(c) minimum gain; and (3) the partner's share of the partnership's excess nonrecourse liabilities. Accordingly, Investor's basis of «M_9Cls_A_Contribution» from its cash contribution is reduced by the net amount of the Code Sections 752(a) and 752(b) adjustments.

Furthermore, all changes in Partnership "liabilities" result in constructive cash contributions and distributions. Upon the liquidation of Investor's Partnership interest, Investor's remaining share of partnership liabilities decreased to zero. Investor originally contributed a liability of «M_4Loan_Amount» to Partnership, and was ultimately relieved of the entire liability. Furthermore, any increases in Investor's share of

⁷⁷ Partnership will not terminate as a result of the liquidation of Investor's Partnership interest. See Treas. Reg. Section 1.708-1(b)(1)(ii). Under Code Section 708(a), an existing partnership is considered as continuing if it is not terminated. Since there were two remaining partners, Presidio's two LLCs, there was no termination under Code Section 708(b)(1)(A). In addition, there was no "sale or exchange" of 50 percent or more of total partnership capital and profits as a result of the liquidation of Investor's 90 percent interest because a liquidation is not considered a "sale or exchange" for purposes of Code Section 708(b)(1)(B). Treas. Reg. Section 1.708-1(b)(1)(ii).

⁷⁸ Code Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount of gain recognized under Section 721(b) to the contributing partner.

⁷⁹ Treas. Reg. Section 1.752-1(f).

⁸⁰ Code Section 752(b).

⁸¹ Code Section 752(a).

Page 41
 «M_1Investor»
 December 31, 1999

Partnership liabilities attributable to other loans of Partnership will have no net effect upon the redemption of Investor's Partnership interest, because a corresponding decrease in Partnership liabilities will result at such time. As a consequence, the total deemed cash distributions to Investor under Code Section 752(b) upon entering into the Partnership and the redemption of Investor's Partnership interest is «M_4Loan_Amount», reducing its basis in its partnership interest to «M_16Premium_Cash».⁸²

Upon liquidation of Investor's Partnership interest, we are of the opinion that it is more likely than not that the difference between the cash received by Investor of «M_17Cash_Distributed» and Investor's adjusted basis amount of «M_16Premium_Cash», plus or minus its allocable share of Partnership income or loss in its Partnership interest, is loss under Code Section 731(a)(2).

E. Applicability of the Code Section 465 "At Risk" Rules and Code Section 469

Generally, the "at risk" provisions limit the ability of certain taxpayers to currently deduct the losses attributable to certain activities to the extent those losses exceed the taxpayer's "amount at risk" in the "activity." Code Section 465(a) provides that in the case of an individual engaged in an "activity" to which the section applies, any "loss from such activity" for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is "at risk for such activity" *at the close of the taxable year*.

The Code Section 465 "at risk" rules apply to individuals directly and to individuals in their capacity as partners in a partnership.⁸³ The "at risk limitation" of Code Section 465 does not apply to a partnership; rather, it applies to the partners.⁸⁴ Consequently, the

⁸² Under Code Section 705(a)(2), a partner's basis is decreased (but not below zero) by the amount of cash distributed to him; the basis of any property distributed to him by the partnership; and his distributive share of partnership losses and nondeductible expenditures of the partnership not properly chargeable to capital account. Treas. Reg. Section 1.752-1(c) provides that any decrease in a partner's share of partnership liabilities is treated as a distribution of money by the partnership to that partner.

⁸³ The "at risk" rules apply to trusts and estates as well. See Code Section 542(a)(2) and S. Rep. No. 94-938, 94th Cong., 2d Sess. 48 (1976), 1976-3 C.B. at 86 (the "Senate Report"); see also Code Section 641(b) (the taxable income of an estate or trust is computed in the same manner as an individual).

⁸⁴ HR Rep. No. 432, 98th Cong., 2d Sess. 1597 (1984).

Page 42
 «M_Investor»
 December 31, 1999

Code Section 465 "at risk" rules have potential applicability to Investor both with respect to its direct investments and its investments through Partnership.

The determination of the extent to which the taxpayer is "at risk" is made on the basis of the facts existing as of the close of the taxable year.⁸⁵ Prop. Treas. Reg. Section 1.465-1(a) provides that a loss is allowed as a deduction only to the extent that the taxpayer is "at risk" *with respect to the activity at the close of the taxable year*. The determination of the amount the taxpayer is "at risk" in cases where the activity is engaged in by an entity separate from the taxpayer is made as of the close of the taxable year of the entity unless otherwise stated.

Accordingly, the analysis with respect to activities undertaken by a partnership is based upon viewing the partnership as a separate entity and making the determination of the amount "at risk" at the partner level. Prop. Treas. Reg. Section 1.465-41 uses the following example of a calendar year individual taxpayer and a partnership with a taxable year ending on June 30 to demonstrate the application of this concept:

Example (5): On July 1, 1976, C, along with many other persons, forms partnership W. C is a calendar year taxpayer and partnership W is on a taxable year ending June 30. On July 1, 1976, C contributes \$3,000 to W. On August 1, 1976, W borrows a sum of money for which C's allocable share of personal liability is \$7,500. On October 1, 1976, W borrows a sum of money under a nonrecourse financing arrangement with respect to which C's allocable share is \$10,000. On March 1, 1977, W repays a portion of the loan for which C is personally liable, thereby reducing C's personal liability to \$6,000. C's allocable share of W's losses for the taxable year ending June 30, 1977, is \$13,000. On September 1, 1977, C contributes unencumbered personal assets with an adjusted basis of \$6,000 to W. On November 1, 1977, W repays another portion of the loan for which C is personally liable, reducing C's personal liability to \$5,000. On December 1, 1977, W repays part of the nonrecourse loan thereby reducing C's allocable portion of the amount outstanding to \$8,000. The amount of loss deduction which C is allowed for 1977 is determined as follows:

Amount at risk in activity as of 7/1/76 (prior to contribution) \$ 0

⁸⁵ Prop. Treas. Reg. Section 1.465-1(a).

Page 43
 «M_Investor»
 December 31, 1999

Plus:	
Contribution -- 7/1/76	\$3,000
Allocable share of loan	<u>\$7,500</u>
	\$10,500
Less:	
Allocable share of net reduction in personal liability	<u>\$1,500</u>
Amount at risk in activity as of 6/30/77	\$9,000

Although C's allocable share of W's losses for the taxable year ending June 30, 1977, is \$13,000, *C's allowable loss deduction is limited to the amount at risk as of the close of the partnership's taxable year.* Thus, C's loss deduction for the taxable year ending December 31, 1977, is \$9,000. The \$4,000 not allowed as a loss deduction in 1977 will be treated as a deduction in 1978. The fact that prior to December 31, 1977, but after the close of W's taxable year on June 30, 1977, C made a contribution to W does not increase the amount of loss which C may deduct for 1977. That amount is limited to the amount C was at risk in the activity as of the close of W's taxable year.

Prop. Treas. Reg. Section 1.465-39(c) further provides that the amount a taxpayer is "at risk" in an activity "at the close of a taxable year of the taxpayer" is determined by:

- Increasing the amount "at risk" in the activity by all factors occurring during the taxable year which increase the amount at risk; and
- Decreasing the amount "at risk" in the activity by all factors occurring during the taxable year which decrease the amount "at risk".

In the above example, the "loss from the activity" was a loss generated by a partnership with a June 30 taxable year that overlapped the taxable year of the individual. In the instant case, Partnership redeemed Investor's Partnership interest during the taxable year of Investor.⁸⁶ Furthermore, Partnership generated a loss from its activity. As discussed below, Investor's Partnership interest is part of Investor's existing portfolio of investments, which should constitute an "activity" under Code Section 465(b)(1).

⁸⁶ Since Investor is a disregarded entity for federal tax purposes, references to Investor shall include its single member for purposes of this section of the opinion.

Accordingly, the determination of whether there is a "loss from the activity" would be based upon the income or loss derived from Investor's investment portfolio during the taxable year, including Investor's loss on the redemption of its Partnership interest. Furthermore, to the extent a loss was generated from the activity of the Partnership, the Partnership's activities will be treated as a separate activity for purposes of Code Section 465.

1. Activities Subject to the Code Section 465 Rules

Code Section 465 originally applied to four types of activities: holding, producing, or distributing motion picture films or video tapes; farming; leasing certain tangible personal property; or exploring for, or exploiting, oil and gas resources.⁸⁷ Congress extended the application of the "at risk" rules in 1978 to exploring for, or exploiting, geothermal deposits and to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income not described in Code Section 465(c)(1).⁸⁸ In 1986, the "at risk" rules were extended to cover real estate.⁸⁹

In applying the "at risk" rules, a two-step analysis is required. The scope of an activity first must be defined and then it must be determined whether separate activities should be aggregated or segregated for purposes of applying the "at risk" rules. The Code Section 465 Proposed Regulations provide only limited guidance regarding how to determine the scope of the activities in which a taxpayer is engaged. If two activities are interrelated, it is not clear whether there are two activities or only one.

Code Section 465 applies to each activity engaged in by the taxpayer in carrying on a trade or business or for the production of income.⁹⁰ Although a partnership itself is not subject to the "at risk" rules, the nature of any activity involving a partner is determined at the partnership level. Investor engages in its activity with respect to the investments made by Partnership for the production of income. Thus, the "at risk" activity of Investor includes its investments through Partnership. In addition, Investor invests directly in marketable securities and other financial instruments on its own account. Investor's direct investments in marketable securities and other financial instruments also constitute an "at risk" activity. Accordingly, Investor's investment portfolio

⁸⁷ Code Section 465(c)(1).

⁸⁸ Code Section 465(c)(1)(E); Code Section 465(c)(3).

⁸⁹ P.L. 99-514, Section 503(a).

⁹⁰ Code Section 465(c)(3).

Page 45
 «M_1Investor»
 December 31, 1999

consists of a combination of Investor's direct investments and investments through Partnership. By design, Investor's investment strategy necessitates an integration of risk positions with respect to all the investments composing the portfolio in order to optimize investment returns. Accordingly, in an economic sense, Investor's investment activities are interdependent and integrated.

However, for purposes of Code Section 465, Investor's direct investment activity and its investment through Partnership would constitute two separate "at risk" activities. With respect to carrying on a trade or business under the Code Section 465(c)(3) rules, if a taxpayer actively participates in the management of such trade or business, then all activities comprising the trade or business are aggregated for purposes of the "at risk" rules.⁹¹ No such rules are provided for the production of income. In addition, Code Section 465(c)(3)(C) provides that activities are aggregated or treated as separate activities to the extent prescribed by the Treasury regulations. No such Treasury regulations have been proposed or adopted since the enactment of the provision in 1978.

Until Treasury regulations are released defining parameters for aggregation and segregation of activities relating to the production of income, Investor should be permitted to combine all directly-held investment activities undertaken pursuant to an integrated investment portfolio strategy into one activity. Because Prop. Treas. Reg. Section 1.465-1(a) treats partnerships as a separate entity for purposes of applying the "at risk" rules, we believe that the intended treatment of activities undertaken by partnerships is to view such activities as separate from related activities undertaken directly by the individual partner. Accordingly, to the extent that Partnership incurred a loss in its investment activities, Investor's allocable share of such loss will be allowed to the extent of Investor's at-risk amount with respect to the Partnership. Furthermore, we believe it is more likely than not that Investor's sale of a portion of its Partnership interest should be treated as an investment activity undertaken by Investor on its own account, and not an activity undertaken by Partnership.

2. The Amount "At Risk"

For purposes of Code Section 465, a taxpayer is considered "at risk" for an activity with respect to the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and the amount borrowed for use in an activity to the extent that the taxpayer is personally liable for repayment of such amount or has pledged

⁹¹ Code Section 465(c)(3)(B).

Page 46
 «M_Investor»
 December 31, 1999

property, other than property used in the activity, as security for such borrowed amount (to the extent of the net fair market value of the taxpayer's interest in such property).⁹² A taxpayer is not considered "at risk," however, with respect to amounts protected against loss through nonrecourse financing, guarantees, stop/loss agreements, or other similar arrangements.⁹³

An amount borrowed is not "at risk" with respect to an activity if the amount is borrowed from any person who has an interest in the activity (other than an interest as a creditor in the activity) or from a related person to a person (other than the taxpayer) having such an interest.⁹⁴ This rule applies with respect to any activity engaged in by the taxpayer in carrying on a trade or business or for the production of income only to the extent provided in Treasury regulations.⁹⁵ No such regulations have been proposed or issued.

A taxpayer's amount "at risk" in a partnership is increased by the amount of the partner's distributive share of taxable and tax-exempt income generated from the activity.⁹⁶ Code Section 465(b)(5) provides that if, in any taxable year, the taxpayer has a loss from an activity to which Code Section 465 applies, the amount with respect to which a taxpayer is considered to be "at risk" in subsequent taxable years with respect to that activity is reduced by that portion of the loss which is allowable as a deduction.

The legislative history underlying the enactment of Code Section 465 provides that the "at risk" amount for a partner is computed with reference to the basis of the partner's partnership interest.⁹⁷ The link between the partnership rules and Code Section 465 is corroborated by Private Letter Ruling 9036013 where the Service stated that the

⁹² Code Sections 465(b)(1) and (2).

⁹³ Code Section 465(b)(4).

⁹⁴ Code Section 465(b)(3).

⁹⁵ Code Section 465(c)(3)(D); Alexander v. Commissioner, 95 T.C. 467 (1990), *rev'g on motion for reconsideration*, 59 T.C.M. (CCH) 121.

⁹⁶ Prop. Treas. Reg. Sections 1.465-22, 1.465-23, and 1.465-66. *See also Lansburgh v. Commissioner*, 92 T.C. 448 (1989), (taxpayer's "at risk" amount increased to extent the taxpayer recognizes income with respect to the activity) and Allen v. Commissioner, 55 T.C.M. (CCH) at 688 (1988), (gain recognized on the disposition of the activity or an interest in the activity increases the taxpayer's amount "at risk"). These adjustments reflect the fact that the "at risk" amount is determined in a manner consistent with the determination of the taxpayer's adjusted basis, except that certain nonrecourse debt amounts and amounts protected against loss are not included. *See the Senate Report at 50.*

⁹⁷ S. Rep. No. 938, 94th Cong., 2d Sess. 50 n.8 (1976).

Page 47
 «M_1Investor»
 December 31, 1999

economic risk of loss analysis of Code Section 752 applied to determine a partner's "at risk" amounts.

The "at risk" rules were interpreted in a similar manner to Code Section 752 in Follender, supra, where the Tax Court rejected the Service's position that present value concepts are to be imposed on the "at risk" rules under Code Section 465. Based upon the lack of support in the legislative history or the statutory language of Code Section 465, the Tax Court refused to find an "implied limitation of the borrowed amount to present value,"⁹⁸ observing that "Congress has been explicit in the areas it has chosen to require present value calculations."⁹⁹ The court further stated that "the statute does not allow for present value calculation, expressly or implicitly."¹⁰⁰ Accordingly, the amount of debt contributed to an activity is the "face" amount of the debt, the principal payable.¹⁰¹

There are two general areas of divergence in the application of the principles of the Code Section 465 "at risk" rules and the Code Section 704(d) partnership loss allowance rules. The first difference is that a partner can acquire basis through nonrecourse financing for Code Section 704(d) purposes; whereas, under Code Section 465(b)(4), nonrecourse financing is generally insufficient to create an amount at risk for Code Section 465 purposes. Accordingly, in the instant case, Investor's initial basis in its Partnership interest after contribution of cash subject to the loan is «M_31Cash90_of_the_loan» and Investor's Code Section 465 "at risk" amount is «M_16Premium__Cash».

Second, in the event a partnership interest is sold and the selling partner has suspended, unallowed Code Section 704(d) losses, subsequent gain on the sale of the partnership interest cannot be used to free-up the Code Section 704(d) loss carryover amount. The partnership's taxable year closes with respect to the selling partner under Code Section

⁹⁸ 89 T.C. at 953.

⁹⁹ 89 T.C. at 952.

¹⁰⁰ *Id.*

¹⁰¹ As previously discussed, the application of the time-value-of-money concepts in the Code Section 465 context parallels the base Code Section 752 logic. In the Code Section 752 context, time-value-of-money concepts are only applied in two defined situations: (1) a special rule for nonrecourse liabilities with interest guaranteed by a partner and (2) an unreasonable delay of a partner's obligation to make payments to the partnership.

Page 48
 «M_1Investor»
 December 31, 1999

706(c)(2)(A) and the basis for the partner's partnership interest at that date is zero.¹⁰² This can be contrasted with the Code Section 465 rules which allow an offset of losses suspended under Code Section 465 against income from the sale of a partnership interest, as such income is treated as "income from the activity."¹⁰³ In effect, the Code Section 465 limitation applies at the partner level, while the Code Section 704(d) limitation isolates the disallowed loss at the partnership level.¹⁰⁴

Based on the foregoing analysis, we believe that it is more likely than not that Investor's Code Section 465 "at risk" amount with respect to its investment in Partnership is equal to Investor's cash contribution to Partnership reduced by the amount of nonrecourse debt as described above, «M_16Premium__Cash», plus or minus its allocable share of Partnership income or loss.

3. Application of Code Section 469

Conceptually similar to the application of the Code Section 465 "at risk" rules, the passive activity loss rules of Code Section 469 do not apply directly to partnerships or S corporations, but (as a result of the entity's flow-through nature) apply to the partners or shareholders.¹⁰⁵

The aggregate amount of deductions disallowed for the taxable year under Code Section 469 is generally equal to a net amount designated as the "passive activity loss." A taxpayer's passive activity loss for any taxable year is the excess of the taxpayer's passive activity deductions for the taxable year over the taxpayer's passive activity gross income for the taxable year.¹⁰⁶ Under the regulations, in order to compute a taxpayer's passive activity gross income and passive activity deductions, the taxpayer must first determine the items of gross income "from a passive activity" and the items of deduction that "arise in connection with a passive activity."¹⁰⁷

¹⁰² In *Sennett v. Commissioner*, 80 T.C. 825 (1983), *aff'd per curiam*, 752 F.2d 428 (9th Cir. 1985), the Tax Court concluded that a partner's suspended Code Section 704(d) deductions expire upon the sale of his partnership interest.

¹⁰³ Prop. Treas. Reg. Section 1.465-66(a).

¹⁰⁴ The underlying logic is that at the point that an investor terminates his entire interest in an investment, Code Section 465 should not preclude deduction of any suspended losses.

¹⁰⁵ Code Section 469(a)(2).

¹⁰⁶ Treas. Reg. Section 1.469-2T(b)(1).

¹⁰⁷ Treas. Reg. Sections 1.469-2T(c)(1) and 1.469-2T(d)(1).

Page 49
 «M_1Investor»
 December 31, 1999

Code Section 469(c) states that for purposes of this section the term "passive activity" means any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate.¹⁰⁸ Code Section 469(c)(6) further provides that, *to the extent provided in the regulations*, the term "trade or business" includes any activity in connection with a trade or business or any activity with respect to which expenses are allowable as a deduction under Code Section 212. Treas. Reg. Sections 1.469-1(e)(2) and 1.469-4(b)(1)(i) provide that the term "trade or business activity" includes any activity that involves the conduct of a trade or business within the meaning of Code Section 162.

To date, no regulations have been issued defining the phrase "any activity with respect to which expenses are allowable as a deduction under Code Section 212." However, Treas. Reg. Section 1.469-1T(e)(6) provides that the activity of trading personal property for the account of owners of interests in the activity is not a passive activity, regardless of whether the activity is a trade or business and regardless of a partner's level of participation. Treas. Reg. Section 1.469-1T(e)(6) provides an example of "trading for the account of owners of interests in the activity." This example indicates that a partnership's trading activities consist of "trading for the account of its partners" where the capital employed by the partnership in the trading activity consists of amounts contributed by the partners in exchange for their partnership interests.

The term "personal property" is defined in the regulations to have the same meaning as under Code Section 1092(d), but without regard to Code Section 1092(d)(3) which generally excludes stock from the definition. Under Code Section 1092(d), personal property means any personal property of a type which is "actively traded." Treas. Reg. Section 1.1092(d)-1(a) further provides that actively traded personal property includes any personal property for which there is an established financial market. An established financial market includes an interdealer market. The regulations define an interdealer market as being characterized by a system of general circulation that provides a reasonable basis for determining current fair market value (Reuters screen quotations of indicative terms). Presidio has represented that the contracts entered into by Partnership would be considered actively-traded based upon the above definition of established financial market.

¹⁰⁸ Under Code Section 469(h)(2), a limited partner is presumed not to materially participate in a limited partnership.

Page 50
 «M_Investor»
 December 31, 1999

With respect to the instant case, Investor's participation in the Investment Fund will constitute an activity that is not a passive activity based upon the exception for the "activity of trading personal property for the account of owners of interests in the activity" described in Treas. Reg. Section 1.469-1T(e)(6). Accordingly, the income (or loss) generated by Partnership should not be subject to the limitations under Code Section 469. Such conclusion should extend to any loss generated upon the disposition of Investor's interest in Partnership.

F. Other Tax Provisions and Judicial Doctrines

In arriving at our conclusions, we have considered several other Code provisions, as well as certain judicial doctrines that, if applicable, could impact the tax results of this transaction. These other Code provisions and doctrines are the application of the anti-abuse rules under Treas. Reg. Section 1.1275-2(g) and Treas. Reg. Section 1.701-2 and the application of the business purpose/economic substance/step transaction/substance over form doctrines.

1. Application of Anti-abuse Rule under Treas. Reg. Section 1.1275-2(g)

The anti-abuse rule of Treas. Reg. Section 1.1275-2(g) provides that if a principal purpose of engaging in a transaction is to achieve a result that is unreasonable under Code Sections 163(e), 1271 through 1275, or any related Code Section, the Commissioner can apply or depart from the regulations to achieve a reasonable result. Whether a result is considered unreasonable will depend upon the facts and circumstances surrounding the transaction. A significant fact in making this determination will be whether the treatment of a debt instrument is expected to have a substantial effect on the issuer's or holder's U.S. tax liability. A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of the taxpayer's U.S. tax liability.

The anti-abuse rule provides three examples of the application of its principles. The examples illustrating the anti-abuse rule focus on the following situations:

- Use of the option rules in Treas. Reg. Section 1.1272-1(c)(5) to limit the holder's interest income includible in the period prior to the call date;

Proprietary Material
 Confidentiality Requested

KPMG 0000454

Page 51
«M_Investor»
December 31, 1999

- Use of a contingent payment debt instrument to substantially reduce the holder's interest income by virtue of the application of Treas. Reg. Section 1.1275-4(c); and
- Use of a convertible debt instrument to avoid original issue discount.

None of the examples are on point with the facts in the instant case. The facts of the instant case can be distinguished from the examples illustrating abuse since the issuer properly amortizes the loan issuance premium into income as an offset to its otherwise allowable interest expense deductions, and, similarly, upon repayment of the loan, income or deduction is properly computed under the provisions of Treas. Reg. Section 1.163-13 and Treas. Reg. Section 1.61-12, respectively.

We are not aware of any authority applying the anti-abuse provisions to a case outside of the examples provided in the regulations, such as to a case similar to the instant case. In analyzing whether the tax consequences contained herein are unreasonable under Code Sections 163(e), 1271 through 1275, or any related Code Section, it is useful to determine how a different application of the rules might result in a more reasonable calculation of the present value of the issuer's U.S. tax liability. For example, the Service may apply the anti-abuse rule to change the manner in which the issuer computes:

- The issue price of the loan;
- The accrual of interest expense and amortization of loan premium; and
- The income or deduction upon retirement of the loan.

It is unlikely the Service could apply the anti-abuse rule to change the issue price of the loan since the issue price is a statutory determination under Code Section 1273(b)(2), and the Service has no authority under the anti-abuse regulations to depart from the statute. However, if the Service were to change the issue price of the loan, such change would have the effect of understating or overstating the proper measurement of taxpayer's interest expense under the constant yield method prescribed under the OID rules and regulations. This misstatement would occur due to the difference in the loan's stated interest rate and prevailing market rates.

Proprietary Material
Confidentiality Requested

KPMG 0000455

Page 52
 «M_1Investor»
 December 31, 1999

Furthermore, any increase or decrease in the issue price would impact the calculation of income from the discharge of indebtedness or repurchase premium deduction upon retirement of the loan. An increase by the Service in the loan's issue price would increase the accrued interest expense during the loan term, but decrease the repurchase premium in the year paid. Similarly, a decrease in the loan's issue price by the Service would decrease the accrued interest expense during the loan term, and increase the Partnership's repurchase premium deduction in the year the loan is paid. As a result, it appears unlikely that the Service could apply the anti-abuse rules to the facts of the instant case to achieve a more reasonable tax result.

Based on the existing authority, and the facts and circumstances of the existing case, we believe that it is more likely than not that the described tax consequences of Investor's issuance of the debt instrument will not have a substantial effect on the Investor's U.S. tax liability that could be construed as unreasonable in light of the purposes of Code Sections 163(e), 1271 through 1275, or any related Code section.

2. Application of Anti-Abuse Rules under Treas. Reg. Section 1.701-2

The partnership anti-abuse regulations articulate two broad rules. The first, which we refer to as the "intent of subchapter K" rule, is articulated in Treas. Reg. Section 1.701-2 paragraphs (a) through (d). It provides a framework within which to determine whether a transaction violates the intent of subchapter K, and identifies the remedial steps that the Service may take to correct perceived transgressions. The second, which we refer to as the "abuse of entity" rule is embodied in paragraphs (e) and (f) of Treas. Reg. Section 1.701-2. This rule addresses situations in which a partnership is utilized, in lieu of an alternative business entity (e.g., a corporation), for a purported abusive purpose. When properly invoked, the Commissioner has the authority to treat the partnership as an aggregate of its partners to "carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder."¹⁰⁹

a. Intent of Subchapter K Rule

The partnership anti-abuse regulations purport to grant the Commissioner authority to recast partnership transactions to achieve tax results that are consistent with

¹⁰⁹ Treas. Reg. Section 1.701-2(e).

Page 53
 «M_Investor»
 December 31, 1999

the intent of subchapter K. The anti-abuse rule applies only if (1) the taxpayer has a principal purpose to achieve substantial federal tax reduction, and (2) that tax reduction is inconsistent with the intent of subchapter K.¹¹⁰ The regulations identify three requirements for demonstrating compliance with the "intent" of subchapter K:¹¹¹

- The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.
- The form of each partnership transaction must be respected under substance over form principles.
- The tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income. Clear reflection of income is not required in instances where the inaccurate reflection of income is clearly contemplated by the particular Code or regulation provision being applied.

The preamble to the final regulations explains that the first two "intent" requirements are intended as restatements of existing judicial doctrines.¹¹² As such, these requirements should be considered satisfied where it is determined that the judicial authorities regarding "business purpose" and "substance over form" are satisfied. As subsequently discussed in the Application of the Business Purpose/Economic Substance/Substance over Form Doctrines section of our opinion, we believe it is more likely than not that these judicial authorities are satisfied. Thus, consistent with these findings, we believe it is more likely than not that the first two "intent" requirements are satisfied.

To demonstrate compliance with the third "intent of subchapter K" requirement, a taxpayer must show that the tax consequences under subchapter K to each partner of partnership operations and of transactions involving a partner and the partnership accurately reflect the partners' economic arrangement and clearly reflect the partner's income. Clear reflection of income is not required, however, where the inaccurate

¹¹⁰ Treas. Reg. Section 1.701-2.

¹¹¹ Treas. Reg. Section 1.701-2(a).

¹¹² T.D. 8588, 1995-7 I.R.B. 5, 8; See also Federal Taxation of Partnerships and Partners, (McKee, Nelson, and Whitmire), Chapter 1.05[2][a].

reflection of income is clearly contemplated by the particular Code or regulation section being applied. The regulations set forth factors and examples that provide some limited guidance with respect to this requirement.

b. The Seven Factors

In an instance that a partnership is formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes to achieve tax results that are consistent with the intent of subchapter K. Whether a partnership is used in a manner inconsistent with the intent of subchapter K is determined based upon all the facts and circumstances. The seven factors set forth below may be indicative, but do not necessarily establish, that the partnership is used in such a manner. These factors are illustrative only, and, therefore, may not be the only factors taken into account in making the determination under Treas. Reg. Section 1.701-2. Moreover, the weight given to any factor depends on all the facts and circumstances. The absence or presence of any factor described does not create a presumption that a partnership was (or was not) used in such a manner. Relevant factors include:¹¹³

- The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;
- The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily to provide the claimed tax benefits to the remaining partners;
- One or more partners who are necessary to achieve the claimed tax results have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss

¹¹³ Treas. Reg. Section 1.701-2(c), subparagraphs (1) through (7).

Page 55
 «M_Investor»
 December 31, 1999

guaranty agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

- Substantially all of the partners (measured by number or interests in the partnership) are related (directly or indirectly) to one another;
- Partnership items are allocated in compliance with the literal language of Treas. Reg. Sections 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of Code Section 704(b) and those regulations. In this regard, particular scrutiny is paid to partnerships in which income or gain is specially allocated to one or more partners that may be legally or effectively exempt from federal taxation (for example, a foreign person, an exempt organization, an insolvent taxpayer, or a taxpayer with unused federal tax attributes such as net operating losses, capital losses, or foreign tax credits);
- The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or
- The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).

c. Examples

1) Example 10

In Example 10¹¹⁴ of the regulations, A, B, and C are partners in a partnership, PRS, which has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree that A's interest in PRS, which has a value and basis of \$100x, will be liquidated with a non-depreciable asset and related equipment with two years of cost recovery remaining. Under Code Sections 732(b) and (c), A's \$100x basis in A's partnership interest will be allocated between the non-depreciable asset and the equipment received in the liquidating distribution in proportion to PRS's

¹¹⁴ Treas. Reg. Section 1.701-2(d) Example 10.

Page 56
 «M_1Investor»
 December 31, 1999

bases in those assets. These rules result in a federal tax advantage to A, with no offsetting detriment to B or C. In selecting the assets to be distributed to A, the partnership had a principal purpose to take advantage of the fact that A's basis in the assets will be determined by reference to A's basis in A's partnership interest, thus, in effect, shifting a portion of A's basis from the nondepreciable asset to the equipment, which in turn would allow A to recover that portion of its basis more rapidly.

The example sets forth the law as follows: subchapter K is intended to permit taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. The decision to organize and conduct business through PRS is consistent with this intent. In addition, the first two "intent of subchapter K" requirements are satisfied. The validity of the tax treatment of this transaction is, therefore, dependent upon whether the transaction satisfies (or is treated as satisfying) the proper reflection of income standard. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, the third "intent" rule provides that if the application of a provision of subchapter K produces tax results that do not properly reflect income, but the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision (and the transaction satisfies the first two "intent" requirements), then the application of that provision to the transaction will be treated as satisfying the proper reflection of income standard.

Applying the law to the facts, Example 10 concludes that the transaction is treated as satisfying the proper reflection of income standard included in the third "intent" requirement. A's basis in the assets distributed to it was determined under Code Sections 732(b) and (c). The transaction does not properly reflect A's income due to the basis distortions caused by the distribution and the shifting of basis from a non-depreciable to a depreciable asset. However, the basis rules of Code Section 732, which in some situations can produce tax results that are inconsistent with the proper reflection of income standard, are intended to provide simplifying administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. Taking into account all the facts and circumstances of the transaction, the application of the basis rules under Code Section 732 to the distribution from PRS to A, and the ultimate tax consequences of the application of that provision to subchapter K, are clearly contemplated.

2) Example 11

Page 57
«M_Investor»
December 31, 1999

In Example 11, PRS has for several years been engaged in the development and management of commercial real estate projects. X, an unrelated party, desires to acquire undeveloped land owned by PRS. X expects to hold the land indefinitely after its acquisition. Pursuant to a plan, a principal purpose for which is to permit X to acquire and hold the land but nevertheless to recover for tax purposes a substantial portion of the purchase price for the land, X contributes \$100x to PRS for an interest therein. Subsequently, PRS distributes to X, in liquidation of its interest in PRS, the land and another asset. The second asset is an insignificant part of the economic transaction but is important to achieve the desired tax results. Under Code Sections 732(b) and (c), X's basis in its partnership interest is allocated between the assets distributed in proportion to their bases to PRS. Thereafter, X plans to sell the second asset for its value so that X will, in effect, recover a substantial portion of the purchase price of the land almost immediately. In selecting the assets to be distributed to X, the partners had a principal purpose to take advantage of the fact that X's basis in the assets is determined under Code Sections 732(b) and (c). Thus, in effect, a portion of X's basis economically allocable to the land that X intends to retain shifts to an inconsequential asset that X intends to dispose of quickly. This shift provides a federal tax advantage to X with no offsetting detriment to any of PRS's other partners.

Although Code Section 732 recognizes that basis distortions can occur in certain situations, the provision is intended only to provide ancillary, simplifying tax results for bona fide partnership transactions that are engaged in for substantial business purposes. Code Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining substantially favorable tax results by virtue of the statute's simplifying rules. The transaction does not properly reflect X's income due to the basis distortions caused by the distribution that result in shifting a significant portion of X's basis to this inconsequential asset. Moreover, the proper reflection of income standard is not treated as satisfied, because, taking into account all the facts and circumstances the application of Code Section 732 to this arrangement, and the ultimate tax consequences that would result, were not clearly contemplated by that provision of subchapter K. In addition, by using a partnership, the partners' aggregate federal tax liability would be substantially less than had they owned the partnership's assets directly. Based upon these facts, Example 11 concludes that PRS has been formed and availed of in a manner that is inconsistent with the intent of subchapter K.

d. The Investor and the third “intent” requirement

In the case of the Investor who makes a contribution to Partnership, the factors and examples provide insight as to whether the transactions engaged in by the Investor and Partnership satisfy (or are treated as satisfying) the proper reflection of income standard embodied in the third “intent of subchapter K” requirement. Subchapter K is intended to permit Investor and other taxpayers to conduct joint business activity through a flexible economic arrangement without incurring an entity-level tax. Organizing and conducting business through Partnership is consistent with this intent. Subchapter K is generally intended to produce tax consequences that achieve proper reflection of income. However, this “intent” requirement recognizes that the application of certain provisions of subchapter K may not produce tax results that properly reflect income. In such cases, the application of such a provision of subchapter K to the transaction is treated as satisfying the proper reflection of income standard if the application of that provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

Investor's basis in its interest in Partnership is increased for the cash contributed and decreased by liabilities that are no longer allocated to Investor. As described above, Investor's basis in Partnership is not decreased by the amount of the bond premium obligation because such obligation is not treated as a “liability” for purposes of Code Section 752. As a result of this treatment of the bond premium obligation, the transaction may not properly reflect Investor's income as the basis in Investor's Partnership interest shifts (pursuant to Code Section 732) to the cash received by Investor when its interest in Partnership is sold. However, these rules (Code Sections 752 and 732) are intended (notwithstanding the potential that tax results inconsistent with the proper reflection of income standard may occur) to provide simplified administrative rules for bona fide partnerships that are engaged in transactions with a substantial business purpose. In particular, the Code Section 752 regulations do not account for the effect of the time value of money (except in limited circumstances that are not applicable here) to simplify the application of those rules to partnership transactions.

The instant case is readily distinguishable from Example 11. In Example 11, the plan or arrangement to reduce X's federal tax liability was structured so that X could obtain the tax results with minimal economic risk (i.e., X's participation in the partnership is terminated subsequent to its contribution to the partnership “at a time when the value of the partnership's assets have not materially changed”). Investor, however, is not

Page 59
 «M_Investor»
 December 31, 1999

afforded such protections. Investor's interest in Partnership is liquidated only after being exposed to the risks associated with the Investment Fund. While Investor could exit the Investment Fund after certain intervals of time and request to be redeemed from Partnership, Investor's economic return from Partnership is dependent upon the Partnership's performance while Investor is a member. In addition, Investor is not compelled as a legal or practical matter to exercise its rights to exit the Investment Fund.¹¹⁵

Based on the foregoing, we believe it is more likely than not that Investor's investment in the Investment Fund through Partnership will not be recast pursuant to the "intent of subchapter K" rule.

e. Abuse of Entity Rule

Under the abuse of entity rule,¹¹⁶ the Service is allowed to treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Code or the regulations promulgated thereunder.¹¹⁷ This rule will not apply in situations where a provision in the Code or the regulations prescribes entity treatment for a partnership (either in whole or in part) and that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.¹¹⁸ The abuse of entity rule is separate and distinct from the intent of subchapter K rule. In other words, the Service may invoke the abuse of entity rule to ignore the subject partnership, and analyze the tax effects of a transaction as if they were engaged in directly by the partners of the partnership.

The Service illustrates the abuse of entity rule by way of three examples. The first two examples identify situations where the interposition of a partnership is intended to avoid application of unfavorable provisions applicable to corporations. Example 1 involves a transaction that tries to avoid limitations imposed by Code Section 163(e)(5). Example 2 involves a transaction attempting to avoid the application of Code Section 1059. Both of these Code sections specifically authorize regulatory authority to prevent taxpayers from using partnerships to avoid application of these sections. The Service will utilize

¹¹⁵ See Treas. Reg. Section 1.701-2(d), Example 4 (which concludes that a transaction that includes an option to exit a partnership does not violate the partnership anti-abuse provisions).

¹¹⁶ See Treas. Reg. Sections 1.701-2(e) and (f).

¹¹⁷ Treas. Reg. Section 1.701-2(e)(1).

¹¹⁸ Treas. Reg. Sections 1.701-2(e)(2)(i) and (ii).

Page 60
 «M_Investor»
 December 31, 1999

its ability to invoke the abuse of entity rule in these types of situations.

Example 3 describes the use of a domestic partnership by a domestic U.S. corporation to improve that corporation's ability to utilize its share of foreign tax credits in respect of foreign country taxes expected to be incurred by a foreign corporation wholly-owned by the partnership. In this case, the Service observes that Code Sections 957(c) and 7701(a)(30) together require that the partnership be treated as an entity with respect to the issue of defining a U.S. shareholder and, thus, determining controlled foreign corporation ("CFC") status. The example also asserts that the use of the domestic partnership to qualify the foreign corporation as a CFC, and, thus, for the favorable foreign tax credit look-through rules of Code Section 904(d)(3), was clearly contemplated by Congress. Accordingly, the example concludes that the Service in this instance would be prevented from recasting the partnership as an aggregate of its partners by operation of Treas. Reg. Section 1.701-2(e).¹¹⁹

In contrast to the "intent of subchapter K" rule, the Service can invoke the abuse of entity rule of Treas. Reg. Section 1.701-2(e) to carry out the "purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder." Moreover, the Service claims the power under this rule to treat a partnership as an aggregate of its partners regardless of whether the partnership is imbued with economic substance. Accordingly, the Service could potentially invoke this rule if it determined that the tax consequences of the transaction involving Investor and Partnership were, in the Service's view, in conflict with the "purpose of any provision" of the Code or regulations.

The only constraint to which the Service's general capacity to invoke the abuse of entity rule is Treas. Reg. Section 1.701-2(e)(2). Under this section, the treatment of a partnership as an entity for purposes of applying a particular provision of the Code is respected if (i) the provision prescribes the treatment of a partnership as an entity, in whole or in part, and (ii) that treatment, and the ultimate tax results (which flow from that treatment), are clearly contemplated by that provision.¹²⁰

The meaning of the phrase "prescribed entity treatment" is illustrated in Treas. Reg. Section 1.701-2(f), Example 3. This example asserts that Code Sections 957(c) and 7701(a)(30), when taken together, require that a partnership be treated as an entity for

¹¹⁹ Treas. Reg. Section 1.701-2(f), Example 3.

¹²⁰ Treas. Reg. Sections 1.701-2(e)(2)(i) and (ii).

Page 61
 «M_Investor»
 December 31, 1999

purposes of determining who is a U.S. shareholder in a foreign corporation and, thus, determining controlled foreign corporation (CFC) status. Code Section 7701(a)(30) states that the definition of the term "U.S. Person" includes a domestic partnership. Code Section 957(c) provides that, for purposes of Subpart F (and the CFC rules), the term "U.S. Person" has the meaning assigned to it by Code Section 7701(a)(30). Accordingly, for purposes of the CFC rules, a domestic U.S. partnership which holds stock in a CFC is treated as a U.S. shareholder. Evidently, the Service believes that entity treatment is "prescribed" in such a case because the partnership's entity-level stock ownership is respected (not disaggregated and attributed to its partners) for purposes of determining the level of U.S. shareholder stock ownership in a foreign corporation.

The tax benefits associated with Investor's investment in Partnership are not derived by avoiding or enhancing results achieved under a Code section outside of subchapter K. Rather, it is subchapter K itself, in particular Code Sections 752 and 732, which drives the tax results for Investor. Both Code Sections 752 and 732 treat a partnership as an entity as opposed to an aggregate of its partners. Such treatment of a partnership as an entity is clearly contemplated by Code Sections 752 and 732. In these circumstances, we believe it is more likely than not that Partnership will not, for purposes of determining the federal tax treatment of Investor's investment in the Investment Fund through Partnership, be recast as an aggregate of its partners pursuant to the "abuse of entity" rule.

3. Application of the Business Purpose/Economic Substance/Substance over Form Doctrines

In order for losses arising from investments in financial instruments to be deductible, the transaction or series of transactions that gave rise to such losses must have economic substance, a business purpose, and a form that reflects their substance. A series of transactions will not be respected unless the transactions have economic substance separate and distinct from the economic benefit achieved solely by tax reduction.

a. Judicial Development of the Business Purpose/Economic Substance/Substance over Form Doctrines

Proprietary Material
 Confidentiality Requested

KPMG 0000465

Page 62
 «M_Investor»
 December 31, 1999

The seminal case dealing with the necessity of having economic substance and a business purpose to effectuate a substantive tax transaction is Gregory v. Helvering.¹²¹ decided in 1935. In Gregory, the taxpayer attempted to use the Code's reorganization provisions to convert a taxable dividend of corporate property into a capital gain transaction involving that same property. The taxpayer in Gregory owned 100% of a corporation that owned operating assets as well as passive, appreciated marketable securities. The taxpayer wanted to extract the securities from the corporation and sell them, but wanted to avoid dividend treatment. To accomplish this result, the taxpayer formed a new corporation ("Newco") and had the corporation holding the securities transfer the securities to Newco in exchange for Newco stock. The Newco stock was then distributed to taxpayer who immediately thereafter liquidated Newco. The taxpayer then sold the marketable securities and reported a capital gain. The series of transactions were undertaken over a six-day period.

Gregory is typically described as a business purpose case. It is also a substance over form case and is indicative of how the doctrines interrelate. The Supreme Court began its analysis of the transaction by stating that "if a reorganization in reality was effected...the ulterior [i.e., tax avoidance] purpose ...will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted...But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."¹²²

The above observation by the Court acknowledges that a taxpayer may use the form of a transaction to minimize taxes, but there must be an underlying business purpose. Specifically, the Court noted that:

...when subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose – a mere

¹²¹293 U.S. 465 (1935).

¹²²Gregory, 293 U.S. at 468.

Page 63
 «M_Investor»
 December 31, 1999

device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner.¹²³

Accordingly, even if a taxpayer purports to reorganize a business and executes the transaction in a form which fits within the Code's definition of a tax-free transaction, the courts will look beyond the form to determine whether the purported business reorganization, in substance, occurred. In addition, a taxpayer must have a business purpose to support a transaction that is structured to reduce taxes.

In 1960, the Supreme Court, citing Gregory, held that, just as there was never a business reorganization in Gregory, there was never a business loan in Knetsch v. United States.¹²⁴ The Court noted that it was "patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction."¹²⁵ The taxpayer in Knetsch purchased 10, 30-year deferred annuity savings bonds, financed by a down payment and funds borrowed from the issuer against their cash surrender value. The basis for the Court's conclusion that the transaction was a sham was that the taxpayer was paying interest to the issuer of the bonds at the rate of 3.5 percent on its loan to him, while the investment was growing in value by only 2.5 percent. The net annual cash loss of 1 percent was incurred only to achieve a tax deduction for the interest paid.

Whereas Gregory and Knetsch involved relatively transparent tax avoidance schemes, the subsequently decided sale-leaseback cases involved more sophisticated transactions which combined differing levels of tax avoidance and non-tax motives. The seminal case in the sale-lease back area is the Supreme Court's decision in Frank Lyon Co. v. United States.¹²⁶ In the 1978 decision, the Supreme Court held that where there is a genuine multiple-party transaction with economic substance, which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties.

¹²³ Gregory, 293 U.S. at 469.

¹²⁴ 364 U.S. 361 (1960).

¹²⁵ Knetsch, 364 U.S. at 361.

¹²⁶ 435 U.S. 561 (1978).

In 1990, the Court of Appeals for the Second Circuit construed the Supreme Court's opinion in Frank Lyon Co. to affect the form versus substance issue as follows:

While we exalt substance over form, we do not ignore the form. The touchstone in determining whether the form of an agreement should govern is the opinion of the Supreme Court in Frank Lyon, which held that agreements which were intended to have economic substance, as opposed to mere tax avoidance, should be given effect for tax purposes...That opinion set forth several factors...The first factor inquires whether there is a legitimate non-tax business reason for the form; in other words, were the parties motivated at least in part by reasons unrelated to taxes?... The second...factor requires that the agreement have non-tax "economic substance."... We have construed that factor to require a "change in the economic interests of the relevant parties." ...¹²⁷

b. Application of the Step-Transaction Doctrine

The judicially created doctrine of substance over form is sometimes referred to as the step-transaction doctrine. In general, the step-transaction doctrine has been used by the courts to determine whether the substance of a series of transactions undertaken by a taxpayer should prevail over the form of the transactions as constructed by the taxpayer. Application of the step-transaction doctrine by the courts can be described as amorphous. One of the more insightful observations that has been made in applying the doctrine was by Judge Easterbrook in Sears Roebuck & Co. v. Commissioner:¹²⁸ "substance prevails over empty forms." As articulated by the Tax Court, the step-transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance integrated, interdependent, and focused toward a particular result."¹²⁹

¹²⁷ Newman v. Commissioner, 902 F.2d 159, 163 (2d Cir. 1990). In Newman, the court vacated and remanded the decision of the Tax Court and concluded that an individual taxpayer was not precluded by former Code Section 46(e)(3) from claiming the investment tax credit on equipment that was subject to an operating agreement. The court held that the operating agreement between an employer and an independent trucking contractor was a valid contract and not a lease. —

¹²⁸ 972 F.2d 858, 862 (7th Cir. 1992).

¹²⁹ Esmark, Inc. v. Commissioner, 90 T.C. 171, 195 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989).

Page 65
 «M_Investor»
 December 31, 1999

In cases where the courts have found that the taxpayer has entered into a series of transactions that are in substance a single or indivisible transaction, they have applied the step-transaction doctrine to disregard the intermediary steps and give credence only to the end result.¹³⁰ The courts have traditionally applied three basic formulations of the doctrine. These are the "binding commitment," the "mutual interdependence," and the "end result" tests.¹³¹

The "binding commitment" test. The "binding commitment" test is the narrowest and most formalistic of the three formulations of the step-transaction doctrine. This approach integrates a series of transactions only if there is a binding legal commitment to undertake each of the steps.¹³² The "binding commitment" test is primarily directed at transactions where the transactions under consideration span several tax years and at the time the first transaction is undertaken, there is a binding commitment to undertake the subsequent transactions.¹³³

The "end result" test. In contrast to the "binding commitment" test, which looks to formal commitment as evidence of taxpayer intent, the "end result" test integrates a series of steps into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be undertaken for the purpose of reaching an ultimate result.¹³⁴ The broadest in scope of the three approaches, the "end result test" focuses upon the subjective intent of the parties involved and whether, as revealed by the substance of the transaction, the ultimate result was intended from the outset.¹³⁵ Where such intent has been present, courts have been disposed to combine purportedly separate steps and bind taxpayers to the tax consequences of an integrated transaction. However, the courts have generally been reluctant to recharacterize a transaction by inventing steps not actually taken by the taxpayer under scrutiny.¹³⁶

¹³⁰ See e.g., Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 198 (1989).

¹³¹ McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524-525 (7th Cir. 1982); Cal-Maine Foods, Inc. v. Commissioner, 93 T.C. 181, 198-199 (1989); and Penrod v. Commissioner, 88 T.C. 1415, 1429 (1987).

¹³² Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

¹³³ Commissioner v. Gordon, 391 U.S. 83, 96; Redding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), cert. denied 450 U.S. 913 (1981), rev'g 71 T.C. 597 (1979); and King Enterprises, Inc. v. U.S., 418 F.2d 511, 518 (Ct. Cl. 1969).

¹³⁴ King Enterprises, Inc. v. U.S., 418 F.2d 511, 516 (Ct. Cl. 1969).

¹³⁵ King Enterprises, Inc. v. U.S., 418 F.2d 511, 518 (Ct. Cl. 1969).

¹³⁶ Esmark, Inc. v. Commissioner, 90 T.C. 171, 196 (1988).

Page 66
 «M_Investor»
 December 31, 1999

The "mutual interdependence" test. The "mutual interdependence" test requires the integration of a series of transactions only if each transaction is so interdependent on the others that the legal relationships created by each step is fruitless without the completion of the series.¹³⁷ This approach focuses not upon ultimate results but rather on the relationship between steps.¹³⁸ Its application is appropriate in instances where it is "unlikely that any one step would have been undertaken except in contemplation of the other integrating acts...."¹³⁹ For example, where the taking of one purportedly separate step in a transaction has been contingent on completion of another, courts have been unwilling to accord the steps independent significance and have integrated them into a single transaction for tax purposes.¹⁴⁰

When such interlocking legal relationships are absent, however, courts have been reluctant to integrate multi-step transactions under the "mutual interdependence" approach. In *Redding v. Commissioner*,¹⁴¹ for example, the taxpayer had received a distribution of transferable stock warrants from a corporation in which the taxpayer held common stock. The warrants entitled the taxpayer to purchase, for additional consideration, stock in the corporation's wholly-owned subsidiary. The taxpayer exercised all the warrants issued to him and purchased stock in the subsidiary. The Tax Court, in applying the step-transaction doctrine, concluded that the warrant distribution and acquisition of subsidiary stock ought to be treated as a single transaction involving the distribution of the subsidiary's stock to the taxpayer. Having also concluded that the other necessary requirements of Code Section 355 had been met, the Tax Court held that the overall transaction qualified as a Code Section 355 spin-off and should, therefore, be tax-free to the taxpayer.¹⁴² On appeal by the Service, however, the Seventh Circuit, in reversing the Tax Court, refused to construe the warrant distribution and subsequent stock purchase as a single transaction under the "mutual interdependence" test.¹⁴³

¹³⁷ *American Bantam Car Company v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). See also *Redding v. Commissioner*, 630 F.2d 1169, 1177; *Dyess v. Commissioner*, 65 T.C.M. (CCH) 2717 (1993), *aff'd*, 25 F.3d 1119 (5th Cir. 1994).

¹³⁸ *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520, 524.

¹³⁹ *Kuper v. Commissioner*, 533 F.2d 152, 156 (5th Cir. 1976).

¹⁴⁰ *Associated Wholesale Grocers, Inc. v. U.S.*, 927 F.2d 1517 (10th Cir. 1991).

¹⁴¹ 630 F.2d 1169, 1175 (7th Cir. 1980), *cert. denied* 450 U.S. 913 (1981), *rev'g* 71 T.C. 597 (1979).

¹⁴² *Redding*, 71 T.C. at 597.

¹⁴³ *Redding*, 630 F.2d at 1178. The judgment was based on the fact that none of the shareholders of the corporation (including the taxpayer) were under any obligation to exercise the warrants distributed to them. In addition, the warrants were transferable to non-shareholders, and the underwriters involved had

Page 67
 «M_1Investor»
 December 31, 1999

When the step-transaction doctrine is employed to eliminate transitory steps, it overlaps and becomes indistinguishable from the business purpose doctrine (under which the unnecessary step is disregarded because it is lacking in business purpose) and the substance over form doctrine (nullifying the unnecessary step as a formality that merely obscures the substance of the transaction). In Tandy Corp. v. Commissioner,¹⁴⁴ the Tax Court stated:

When a taxpayer adheres strictly to the requirements of a statute intended to confer tax benefits, whether or not steps in an integrated transaction, when the result of the steps is what is intended by the parties and fits within the particular statute, and when each of the several steps and the timing thereof has economic substance and is motivated by valid business purposes, the steps shall be given effect according to their respective terms.¹⁴⁵

The Tax Court's logic in Tandy Corp. is consistent with the Service's position in Revenue Ruling 79-250.¹⁴⁶ In this ruling the Service stated that formally separate transactions will be respected and that the step-transaction doctrine will not apply if each transaction demonstrates independent economic significance, is not subject to attack as a sham, and is undertaken for valid business purposes and not for mere tax avoidance.

In the instant case, the following separate transactions were undertaken:

- Investor entered into the «M_4Loan_Amount» loan with a third party bank.

agreed to purchase (at a price somewhat reduced from the actual exercise price of the warrants themselves) any stock of the subsidiary not acquired by exercise of the warrants. Therefore, as the appeals courts pointed out, "the money would have come in and the stock gone out with or without the exercise of the warrants." Redding, 630 F.2d at 1177. Noting that the primary objective of the warrant distribution was the raising of new capital, the court also decided that it had economic significance independent of any individual shareholder's decision to exercise and to actually acquire the subsidiary's stock. Hence, the necessary level of interdependence between the two steps was lacking, and the court found little evidence that the corporation had acted in concert with its shareholders to achieve the joint objective of a tax-free spin off of the subsidiary. Redding, 630 F.2d at 1178.

¹⁴⁴ 92 T.C. 1165 (1989).

¹⁴⁵ Tandy Corp., 92 T.C. at 1173.

¹⁴⁶ 1979-2 C.B. 156.

Page 68
 «M_1Investor»
 December 31, 1999

- Investor contributed «M_9Cls_A_Contribution» in cash to Partnership in a Code Section 721 transaction.
- Partnership undertook substantive investment activities.
- Investor opted to withdraw from the Investment Fund and its Partnership interest was redeemed by Partnership.

We believe that it is more likely than not that each of the above steps will be respected and the step-transaction doctrine will not apply because:

- Investor is the true borrower and Investor entered into the loan for a valid business purpose (i.e., by leveraging its capital contribution to Partnership outside Partnership, Investor was able to guarantee a minimum initial amount of financial leverage).
- The transactions entered into by Investor, as a member in Partnership, had inherent economic risks where there was the potential for gain or loss and Investor has represented that it had a reasonable expectation of making a pre-tax profit.
- Investor, the Managing Member, the Class B Member and «M_5Bank» have represented that they each acted independently and at arm's length with respect to the transactions described herein.
- There was no legally binding agreement, written or otherwise, that compelled Investor to complete the transactions in the way described herein.
- There were no written agency agreements consummated with respect to the transactions undertaken pursuant to the Investment Fund and none of the parties involved held itself out to a third party as an agent of any of the others with respect to these transactions.

c. Application of the Business Purpose/Economic Substance Doctrines

Page 69
 «M_Investor»
 December 31, 1999

In Revenue Ruling 99-14,¹⁴⁷ the Service set forth its views on how the economic substance and business purpose doctrines applied within the context of “lease-in, lease-out” (“LILO”) deals. In the analysis of its position that the transaction did not produce the sought after tax result of deductible lease and interest payments, the Service discussed its view of the relevant authorities. The underlying economics of the transactions described in the revenue ruling are significantly different from those of the instant case;¹⁴⁸ however, a number of the cases cited in the ruling have potential applicability to the instant case.

In the ruling, the Service concluded that the LILO transaction lacked the potential for significant economic consequences other than the creation of tax benefits based upon the following observations:

- During the primary term of the sublease,¹⁴⁹ the taxpayer’s obligations to provide property were completely offset by its right to use property;
- The taxpayer’s obligations to make debt service payments on the loans were completely offset by the taxpayer’s right to receive rent on the sublease; and
- The taxpayer’s economic exposure to the headlease residual was rendered insignificant by an option structure and the pledge of the securities that defeased the other party’s option payment.

The Service concluded that the “only real economic consequence” of the LILO transaction during the 20-year primary term of the sublease was the taxpayer’s pre-tax return. The Service then concluded that the pre-tax return was too insignificant, when compared to the taxpayer’s after-tax yield, to support a finding that the transaction had significant economic consequences other than the creation of tax benefits.¹⁵⁰

¹⁴⁷ 1999-13 IRB 3.

¹⁴⁸ In a typical LILO transaction, there is minimal, if any, inherent economic risk incurred as a result of the circular flow of cash payments. Most leveraged leases are structured based upon the guidelines contained in Revenue Procedure 75-21, 1975-1 C.B. 715, which has only a nominal profit requirement.

¹⁴⁹ In a LILO transaction, property is leased to the taxpayer under a “headlease” and the taxpayer immediately leases the property back under a “sublease.”

¹⁵⁰ Revenue Ruling 99-14 is effectively a restatement of the Service’s position on how to interpret the “for profit” standard as articulated in Notice 98-5, 1998-3 IRB 49. In the notice, the Service takes the position that a taxpayer is not entitled to foreign tax credits from an arrangement where “the reasonably expected

Page 70
 «M_Investor»
 December 31, 1999

The Service initially cited Frank Lyon Co., *supra*, in the ruling. The Service stated that in assessing the economic substance of a transaction, a key factor is whether the transaction has any practical economic effect other than the creation of tax losses. The Service further observed that courts have refused to recognize the tax consequences of a transaction that does not appreciably affect the taxpayer's beneficial interest except to reduce tax and that the presence of an insignificant pre-tax profit is not enough to provide a transaction with sufficient economic substance to be respected for tax purposes. Knetsch, *supra*, ACM Partnership v. Commissioner¹⁵¹ and Sheldon v. Commissioner¹⁵² were cited in support of its observations.

The Service noted that in determining whether a transaction has sufficient economic substance to be respected for tax purposes, courts have recognized that offsetting legal obligations, or circular cash flows, may effectively eliminate any real economic significance of the transaction. For example, in Knetsch, the taxpayer purchased an annuity bond using nonrecourse financing. However, the taxpayer repeatedly borrowed against increases in the cash value of the bond. Thus, the bond and the taxpayer's borrowings constituted offsetting obligations. As a result, the taxpayer could never derive any significant benefit from the bond. The Supreme Court found the transaction to be a sham, as it produced no significant economic effect and had been structured only to provide the taxpayer with interest deductions.

In Sheldon, the Tax Court denied the taxpayer the purported tax benefits of a series of Treasury bill sale-repurchase ("repo") transactions because they lacked economic substance. In the transactions, the taxpayer bought Treasury bills that matured shortly after the end of the tax year and funded the purchase by borrowing against the Treasury bills through simultaneously entering into a series of repo transactions.¹⁵³ The taxpayer accrued the majority of its interest deduction on the borrowings in the first year while deferring the inclusion of its economically offsetting interest income from the Treasury bills until the second year. In ten out of the eleven repo transactions in question, the repos each bore an interest rate higher than the yield of the corresponding Treasury bill.

economic profit is insubstantial compared to the value of the foreign tax credits expected to be obtained as a result of the arrangement."

¹⁵¹ ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998).

¹⁵² Sheldon v. Commissioner, 94 T.C. 738, (1990).

¹⁵³ The taxpayer in Sheldon purchased Treasury bills and, in order to finance the purchase, simultaneously entered into a series of repo transactions (in which it sold the T-bills back to the dealers from which it had purchased them and agreed to repurchase the T-bills in the future for the same price plus interest).

Page 71
 «M_Investor»
 December 31, 1999

The court concluded that "the situation in form and substance is no different from that in Goldstein."¹⁵⁴ The Tax Court in a nine to seven decision denied the taxpayer the tax benefit of the transactions because the real economic impact of the transactions was "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions."¹⁵⁵

The Sheldon majority focused on the year-end timing of the transactions, their non-existent or negligible profit potential, and the use of repos to maturity to conclude that, like the transactions at issue in Goldstein, the repo transactions had no tax independent purpose:

"We recognize that taxpayers may structure their transactions so as to obtain the maximum benefit legally obtainable. . . Here, however, the sole objective was to obtain the interest deduction. This is abundantly evidenced by the use of repos to market with locked-in losses in the transactions with no potential for any profit. In instances where intermediate repos could have or did generate some gain from the carry, these amounts were nominal, either fixed or short-term and stable and, in any event, merely reduced fixed losses by relatively insignificant amounts."¹⁵⁶

The dissenting judges believed that the majority misapplied Goldstein and, in fact, created a new and inappropriate standard for testing interest deductions. In the dissent's view, the proper Goldstein test for determining whether interest is deductible is whether the underlying transaction has a tax-independent purpose. Accordingly, the majority erred in introducing a profit objective standard and concluding that the de minimis profit potential deprived taxpayers of interest deductions. The dissent in Sheldon was willing to recognize the applicability of Goldstein to trades that ended in repos to maturity that effectively locked in losses and negated profitability. However, the dissenting judges

¹⁵⁴ Goldstein v Commissioner, 364 F.2d 734 (2nd Cir. 1966), is subsequently discussed.

¹⁵⁵ Sheldon, 94 T.C. at 769. In total, the transactions produced \$18,381 of net gain on an investment of \$1 million. The point of controversy in Sheldon was the court's observation that the non-tax business purpose should be weighted against the tax purpose. The court noted the profits generated were nominal and insignificant when considered in comparison with the claimed deductions. Although the cases discussed above uniformly support the notion that a taxpayer must have some business purpose, none of the cases attempt to quantify the amount of business purpose necessary for a taxpayer to prevail.

¹⁵⁶ Sheldon, 44 T.C. at 767.

Page 72
 «M_1Investor»
 December 31, 1999

were unwilling to condemn the trades in aggregate because, in the dissent's view, the taxpayer was, at times, exposed to the risk of profit and loss.

Again focusing on a transaction that did not appreciably affect the taxpayer's beneficial interest, the Service observed that in ACM Partnership, *supra*, the taxpayer entered into a near-simultaneous purchase and sale of debt instruments. Taken together, the purchase and sale "had only nominal, incidental effects on [the taxpayer's] net economic position."¹⁵⁷ The court held that transactions that do not "appreciably" affect a taxpayer's beneficial interest, except to reduce tax, are devoid of substance and are not respected for tax purposes.¹⁵⁸

In Revenue Ruling 99-14, the Service's analysis did not cite the case that many view, including the Tax Court in ACM Partnership, as the cornerstone "for-profit" standard case, Goldstein v. Commissioner. Goldstein involved a taxpayer's attempt to use a "T-bill roll" to shelter her Irish Sweepstakes winnings. The plan called for Mrs. Goldstein to borrow a total of \$945,000 from two banks with interest at approximately 4% and to invest in Treasury Bills yielding 1.5%. Mrs. Goldstein prepaid the interest on her loans in the first year. This prepayment, which she deducted as interest, sheltered much of the Sweepstakes winnings. Eventually, the T-bills were sold at a loss on Mrs. Goldstein's behalf and her notes were canceled. The Tax Court disallowed the deductions holding that the transactions were not real and held out no prospect for economic benefit other than tax losses. Citing Knetsch, the Tax Court, noted specifically that "if saving 1958 income taxes was the *only significant benefit* to be derived ... then the Knetsch and Bridges cases require that the deductions for so-called prepaid interest must be denied."¹⁵⁹

To determine whether any "significant benefit" did accrue to the taxpayer, the Tax Court analyzed the underlying economics of the investment and concluded that:

...to have realized anything substantial beyond recovering her said outlay, the Treasury notes would have had to be sold considerably in excess of par, notwithstanding that they bore interest of only 1.5%, and were to mature at par only a short time later ... [Thus, the taxpayer] could not reasonably have had any purpose or intention through the foregoing

¹⁵⁷ ACM Partnership, 157 F.3d at 250

¹⁵⁸ ACM Partnership, 157 F.3d at 248

¹⁵⁹ Goldstein, 44 T.C. at 299.

Page 73
 «M_Investor»
 December 31, 1999

transactions to appreciably affect her beneficial interest except to reduce her taxes.¹⁶⁰

On appeal, the Second Circuit disagreed with the Tax Court in holding that the loans were shams. In this regard, the court noted that the Goldsteins had entered into the transactions with independent financial institutions, that the loans remained outstanding for six months rather than just a few days and that the notes were with recourse. The Second Circuit affirmed the Tax Court, nevertheless, because it found that the Goldsteins had entered into the loan transaction for the sole purpose of securing a large interest deduction. The court noted that "the interest deduction should be permitted whenever it can be said that taxpayer's desire to secure an interest deduction is *only one of mixed motives* that prompts the taxpayer to borrow funds there must be *some substance* to the loan arrangement beyond the taxpayer's desire to obtain tax benefits [emphasis supplied]."¹⁶¹

Several recent court cases have also addressed the economic substance and business purpose doctrine. Three of such cases have addressed a Merrill Lynch investment program involving the purchase and resale of certain notes, which, pursuant to a literal application of the contingent installment sale rules, generated tax losses. First, in ACM Partnership, *supra*, a divided Third Circuit partly affirmed the Tax Court in holding that the economic substance doctrine precluded a partnership's deduction of losses attributable to such investment program; however, the Third Circuit reversed the Tax Court and allowed deductions for "actual economic losses" associated with the program.

ACM Partnership has certain parallels, and significant distinctions, to the instant case. The facts of the case were as follows. In 1988, Colgate incurred a large capital gain on the sale of one of its subsidiaries. Colgate used the proceeds of the subsidiary sale to retire short-term debt and also issued newly established long-term debt in connection with a newly established ESOP. As a result of the debt issuance, Colgate believed that it had a disproportionately large level of long-term debt. Colgate concluded that by acquiring its own debt through a partnership, rather than by simply refinancing it directly, it could pick the most advantageous market timing to actually refinance the debt. In 1989, Merrill Lynch devised a contingent installment note sale transaction

¹⁶⁰ Goldstein, 44 T.C. at 300.

¹⁶¹ Goldstein, 364 F.2d at 740.

Page 74
 «M_Investor»
 December 31, 1999

structured through a partnership that would generate tax losses to offset the gain generated on the subsidiary sale.¹⁶²

The Tax Court was asked to decide three issues: (1) whether the transaction should be disregarded because it lacked economic substance; (2) whether one of ACM's partners, the ABN affiliate, was actually a lender rather than partner; and (3) whether certain partnership allocations lacked substantial economic effect under Code Section 704(b). Because the court found for the Service on the first issue, it did not address the other two issues. In reaching its conclusion, the court discussed a number of major business purpose cases including, among others, Gregory, supra; Kneitsch, supra; Frank Lyon, supra; and Goldstein, supra. The court focused particular attention on Goldstein and a major part of the court's ultimate conclusion is based upon the Goldstein analysis.

The Tax Court in ACM Partnership provided the following test for making its economic substance determination:

...the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it

¹⁶² Consistent with its plan to manage its long-term debt position and to shelter the subsidiary capital gain, in October of 1989, affiliates of ABN Bank ("ABN"), Colgate and Merrill formed ACM Partnership. The ABN, Colgate and Merrill affiliates contributed \$169.3 million, \$35 million and \$600,000 to the partnership and received partnership interests of approximately 82.63%, 17.07% and .29%, respectively. Initially, the partnership placed its \$205 million into a bank account earning interest at 8.75%. On November 3, 1989, the partnership purchased \$205 million of floating rate notes from Citicorp that had a yield of 8.78%. Three weeks later, in order to generate the cash needed to finance the purchase of Colgate long-term debt held by third parties, the partnership sold \$175 million of the Citicorp notes in a taxable installment sale transaction to the Bank of Tokyo and Banque Francaise du Commerce Exterieur. In the sale, the partnership received \$140 million in cash and LIBOR-based installment notes with a present value of \$35 million. Colgate argued that the interest rate sensitivity of the notes allowed the partnership to hedge the interest rate exposure that it had as a holder of the Colgate debt. Colgate took the position that by operation of the installment sale Regulations, the partnership could only use \$29 million of its total \$175 million basis in the Citicorp notes to offset the \$140 million in cash proceeds. As a result, the partnership recognized \$111 million of taxable income in its first year. The income was allocated to the partners in accordance with their partnership percentages so that more than 80% was allocated to the ABN affiliate, which was not subject to U.S. tax and which paid no tax in its country of incorporation. Under the Code Section 453 basis rules, the nearly \$146 million in basis that was not available to offset the gain on the sale was reallocated to the LIBOR notes. The LIBOR notes, thus, became built-in loss assets with a value of \$35 million and a basis of \$146 million.

Page 75
 «M_Investor»
 December 31, 1999

must be evaluated in accordance with commercial practices in the relevant industry.¹⁶³

The court then provided guidance concerning when a transaction is "rationally related" to the taxpayer's situation. According to ACM Partnership, a rational relationship will ordinarily not be found unless the taxpayer had a reasonable expectation that the nontax benefits of the transaction would at least equal the transaction costs. This conclusion effectively follows Goldstein, where the court held that it does not make economic sense to pay 4% for a chance to earn 1.5%.

Based upon a detailed analysis, the Tax Court concluded that the relevant portions of the ACM transactions were economic shams which were devoid of any non-tax business purpose and which did not have a rational nexus to Colgate's stated purpose of liability management. In reaching this conclusion, the court effectively bifurcated the ACM transaction into those components that provided the claimed tax benefit and all other components of the transaction. Although the court found that Colgate had made an overall pre-tax profit on its ACM investment, even after taking into account transaction costs, the court also found that the pre-tax profit of the tax benefit components did not exceed their transaction costs.¹⁶⁴

In its analysis of the economic substance doctrine, the Third Circuit started its economic substance/business purpose discussion from the same basic starting point as the Tax Court, Gregory, *supra*. In Gregory, the Supreme Court held that the form of a transaction must be looked through in order to determine its substance. In this regard, the transaction must be viewed as a whole, and each step is relevant. Whether the taxpayer's transactions had sufficient economic substance to be respected turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them. These are not, the Third Circuit pointed out in ACM Partnership, "discrete prongs of a 'rigid two-step analysis'" but rather are related factors

¹⁶³ ACM Partnership, 73 T.C.M. (CCH) 2189.

¹⁶⁴ The Tax Court found that at the time it entered into the partnership, Colgate's only real opportunity to earn a profit was through an increase in the credit quality of the issuers of the notes, or a 400-500 basis point increase in three-month LIBOR interest rates. The Tax Court found no impact on credit quality was possible as the lenders were already highly rated at the time of the transaction. Moreover, the Tax Court did a six year review of three-month LIBOR rates and did not find an increase of even 300 basis points in the necessary time frame. Since the analysis of the historical data showed no reasonable basis for expecting a profit, the Tax Court ruled against ACM.

Page 76
 «M_Investor»
 December 31, 1999

in the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected."¹⁶⁵

The Third Circuit subsequently refined the Tax Court's economic substance analysis by clarifying that the objective economic consequence test is first applied and then the subjective business motivation is examined, should a taxpayer not satisfy the objective test. The court stated that the inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the "objective economic substance of the transactions" and the "subjective business motivation" behind them.

The court's position in ACM Partnership is an affirmation of the Fourth Circuit's two-pronged subjective and objective tests contained in the Rice's Toyota World v. Commissioner.¹⁶⁶ Rice's Toyota World effectively provides that a transaction is not a sham if it has either "business purpose" (subjective) or "economic reality" (objective). Assuming a transaction has either (or both) of the prongs, it should not be viewed as a sham. The court in ACM Partnership reaffirmed that "business purpose" and "economic reality" (or economic substance) do not constitute discrete prongs of a "rigid two-step analysis," but rather represent related factors, both of which inform the analysis of whether the transaction had sufficient substance to be respected for tax purposes.

To better understand the Third Circuit's position in ACM Partnership, it should be contrasted with the Second Circuit's decision in Goldstein, *supra*, where the court focused on the primacy of actual economic returns in assessing business purpose. The Second Circuit did not attempt to engage in any subjective/objective dichotomy in determining business purpose, but undertook a relatively sophisticated economic analysis to determine whether there was a reasonable expectation of non-tax economic profit. The Third Circuit incorporates the Goldstein logic in its "subjective business motivation" analysis, which looks to intended business purpose and anticipated profitability.

In its appeal, ACM contended that because its transactions on their face satisfied each requirement of the contingent installment sale provisions, it properly deducted the losses arising from its "straightforward application" of these provisions which required it to recover only one-sixth of the basis in the Citicorp notes during the first of the six years

¹⁶⁵ ACM Partnership, 157 F.3d at 247.

¹⁶⁶ 752 F.2d 89 (4th Cir. 1985).

Page 77
 «M_Investor»
 December 31, 1999

over which it was to receive payments.¹⁶⁷ Thus, ACM contended it properly subtracted the remaining basis in the LIBOR notes which included the remaining five-sixths of the basis in the Citicorp notes used to acquire them. Consequently, ACM argued it properly subtracted the approximately \$96 million remaining unrecovered basis in the LIBOR notes from the approximately \$11 million consideration it received upon disposition of those notes and correctly recognized and reported the gains and losses arising from its sale or exchange of property in accordance with Code Section 1001. In his dissent, Circuit Judge McKee agreed.

The Third Circuit's reasoning in coming to its decision first looked to the objective aspects of the economic substance analysis and then to the subjective aspects. With respect to the objective analysis, ACM asserted that the Tax Court was bound to respect the tax consequences of ACM's exchange of Citicorp notes for LIBOR notes because, under Cottage Savings Association v. Commissioner,¹⁶⁸ an exchange of property for "materially different" assets is a substantive disposition whose tax effects must be recognized. The majority found Cottage Savings inapposite, reasoning that the mortgages relinquished by the savings and loan association afforded it "legally distinct entitlements" from the ones it received.

The court observed that the distinctions between the exchange at issue in this case and the exchange before the Court in Cottage Savings predominate over any superficial similarities between the two transactions. The court noted that the taxpayer in Cottage Savings had an economically substantive investment in assets which it had acquired a number of years earlier in the ordinary course of its business operations. The investment had declined in actual economic value by over \$2 million from approximately \$6.9 million to approximately \$4.5 million from the time of acquisition to the time of disposition.¹⁶⁹

¹⁶⁷ Temp. Treas. Reg. Section 15a.453-1(c).

¹⁶⁸ 499 U.S. 554 (1991). In Cottage Savings, the taxpayer, a savings and loan association, owned fixed rate mortgages whose value had declined as interest rates had risen during the preceding decade. The taxpayer simultaneously sold those mortgages and purchased other mortgages which were approximately equal in fair market value, but far lower in face value than the mortgages which the taxpayer relinquished. The Court found that the exchange for different mortgages of equivalent value afforded the taxpayer "legally distinct entitlements," and thus was a substantive disposition which entitled the taxpayer to deduct its losses resulting from the decline in value of the mortgages during the time that the taxpayer held them.

¹⁶⁹ In Cottage Savings, the taxpayer's relinquishment of assets (so altered in actual economic value over the course of a long-term investment) stood in "stark contrast" to ACM's relinquishment of assets that it had acquired 24 days earlier *under circumstances which assured that their principal value would remain*

Page 78
 «M_Investor»
 December 31, 1999

Based upon Cottage Savings, the Third Circuit majority in ACM Partnership effectively expanded upon the terminology used by the Tax Court by introducing the concept of a "bona fide" loss.¹⁷⁰ The court noted that the Supreme Court emphasized in Cottage Savings that deductions are allowable only where the taxpayer has sustained a "bona fide" loss as determined by its "[s]ubstance and not mere form."¹⁷¹ According to ACM's own synopsis of the transactions, the contingent installment exchange would not generate actual economic losses. Rather, ACM would sell the Citicorp notes for the same price at which they were acquired, generating only tax losses which offset precisely the tax gains reported earlier in the transaction with no net loss or gain from the disposition.

In order to understand the court's use of the "bona fide" loss logic and determine the applicability of the resulting dicta in other contexts, one must carefully read footnote 31. In this footnote the court differentiates a "bona fide" loss from the ACM loss:

While it is clear that a transaction such as ACM's that has neither objective non-tax economic effects nor subjective non-tax purposes constitutes an economic sham whose tax consequences must be disregarded, and equally clear that a transaction that has both objective non-tax economic significance and subjective non-tax purposes constitutes an economically substantive transaction whose tax consequences must be respected, it is also well established that where a transaction objectively affects the taxpayer's net economic position, legal

constant and that their interest payments would not vary materially from those generated by ACM's cash deposits. The court further distinguished the two transactions by making the following observation:

...while the dispositions in Cottage Savings and in this case appear similar in that the taxpayer exchanged the assets for other assets with the same net present value, beneath this similarity lies the more fundamental distinction that the disposition in Cottage Savings precipitated the realization of *actual economic losses* arising from a long-term, economically significant investment, while the disposition in this case was without economic effect as it *merely terminated a fleeting and economically inconsequential investment, effectively returning ACM to the same economic position it had occupied before the notes' acquisition 24 days earlier.* (Emphasis added). ACM Partnership, 157 F.3d at 251.

¹⁷⁰ Treas. Reg. Section 1.165-1(b) also requires that a loss be "bona fide," and that substance shall govern over form in determining the deductibility of a loss. The conclusion that Investor's loss is "bona fide" under ACM should be equally applicable under Treas. Reg. Section 1.165-1(b).

¹⁷¹ Cottage Savings, 499 U.S. at 567-68 (quoting Treas. Reg. Section 1.165-1(b)).

Page 79
 «M_Investor»
 December 31, 1999

relations, or non-tax business interests, it will not be disregarded merely because it was motivated by tax considerations. See, e.g., Gregory, 293 U.S. at 468-69, 55 S.Ct. at 267 ("if a reorganization in reality was effected . . . the ulterior purpose will be disregarded"), Northern Indiana Pub. Serv. Co., 115 F.3d at 512 (emphasizing that Gregory and its progeny "do not allow the Commissioner to disregard economic transactions . . . which result in actual, non-tax-related changes in economic position" regardless of "tax-avoidance motive" and refusing to disregard role of taxpayer's foreign subsidiary which performed a "recognizable business activity" of securing loans and processing payments for parent in foreign markets in exchange for legitimate profit); Kraft Foods Co. v. Commissioner, 232 F.2d 118, 127-28 & n.19 (2d Cir. 1956) (refusing to disregard tax effects of debenture issue which "affected . . . legal relations" between taxpayer and its corporate parent by financing subsidiary's acquisition of venture used to further its non-tax business interests). In analyzing both the objective and subjective aspects of ACM's transaction in this case where the objective attributes of an economically substantive transaction were lacking, we do not intend to suggest that a transaction which has actual, objective effects on a taxpayer's non-tax affairs must be disregarded merely because it was motivated by tax considerations.¹⁷²

After concluding that the taxpayer did not satisfy its objective economic consequence portion of the economic substance analysis, the Third Circuit then looked to the subjective aspects of the economic substance analysis. In its subjective purpose inquiries, the court determined that the transactions were not intended to serve ACM's professed non-tax purposes and were not reasonably expected to generate a pre-tax profit (a Goldstein-type of analysis). The court stated in footnote 44 that "where such objective economic effects are lacking, scrutiny of the subjective intent behind the transactions becomes an important means of determining whether the transactions constitute a scheme with 'no purpose other than tax avoidance' that may not give rise to deductible losses even where the statute contains no express requirement that the transaction serve a non-tax business purpose."¹⁷³

¹⁷² ACM Partnership, 157 F.3d at 248.

¹⁷³ ACM Partnership, 157 F.3d at 254.

Page 80
«M_Investor»
December 31, 1999

The Third Circuit observed that ACM's stated business purpose for engaging in the transactions, to provide an interim investment until ACM needed its cash to acquire Colgate debt and as a hedge against interest rate risk, did not comport with economic reality or with what actually transpired. In addition, the court agreed with the Tax Court's conclusion that there was no pre-tax profit potential using the Tax Court's bifurcation approach to analyze profitability. Accordingly, the Third Circuit concluded that ACM did not satisfy the subjective business motivation test.

ACM Partnership is an endorsement of the principles previously set forth in cases such as Goldstein, supra, Sheldon, supra, and Wexler, supra. Beyond the base logic of these cases, it is our view that ACM Partnership stands for the simple proposition that a transaction with no reasonable potential for pre-tax profit cannot be salvaged because the taxpayer also has unrelated profit-generating activity.

Since the Third Circuit's decision in ACM Partnership, the Tax Court has denied losses claimed by investors in two other cases involving the Merrill Lynch investment program, ASA Investorings Partnership v. Commissioner¹⁷⁴ and Saba Partnership v. Commissioner.¹⁷⁵ In ASA, the Tax Court ruled that the arrangement between the taxpayer and the accommodating Dutch bank was formed for the purpose of generating tax losses and was not a valid partnership. Like the ACM Partnership transaction, the plan involved a partnership with a foreign partner. The partnership invested in high-grade, floating rate private placement notes, and sold the notes for cash and LIBOR-indexed installment notes. Also, like the ACM Partnership transaction, the ASA transaction entailed interest rate swaps that virtually eliminated the risks to the accommodating parties involved in the transaction. As in ACM Partnership, the Service argued that the Dutch bank was not a partner, but a lender, since the Dutch bank had no entrepreneurial risk in the partnership.

The Tax Court agreed stating that no business purpose existed for the partnership. This conclusion was supported by the existence of hedges and side agreements entered into for the purpose of ensuring the Dutch bank received its required return at little risk. Although partnership formalities were observed and the Dutch bank was not promised a guaranteed return, the bank was receiving a lender's return under the guise of partnership profits. Because partnership profits were insufficient, the parties had to enter into arrangements outside the partnership agreement.

¹⁷⁴ 76 T.C.M. (CCH) 325.

¹⁷⁵ 78 T.C.M. (CCH) 684.

Page 81
 «M_Investor»
 December 31, 1999

Similarly, in Saba, the Tax Court held that a partnership could not deduct losses from transactions almost identical to the investment program involved in ACM Partnership. The Tax Court applied the economic substance doctrine as set forth in ACM Partnership. It conducted both a subjective inquiry as to whether the investment program was carried out for a valid business purpose other than to obtain tax benefits, and an objective inquiry as to whether the investment program had practical economic effects other than the creation of tax benefits.

The Tax Court first rejected the business purposes offered by the taxpayer for its involvement in the investment program, holding that the record contained overwhelming evidence that the partnerships in the investment program were formed solely to generate tax benefits. The Tax Court then noted that even absent a business purpose, a transaction will be respected if it has economic substance. However, given the substantial costs associated with the investment program in Saba, the Tax Court held that the investment program could not generate a profit over the short period in which it was intended to remain open. Thus, the investment program lacked business purpose, lacked economic substance, and accordingly, was held to be an economic sham.

While the Tax Court in Saba concluded that no profit could have been generated over the period of the taxpayer's investment, it also noted that "relatively modest profits are insufficient, *standing alone*, to clothe the disputed CINS transactions with economic substance."¹⁷⁶ The Tax Court then cited the Seventh Circuit in Yosha v. Commissioner¹⁷⁷ in noting that a transaction has economic substance when it is such that people enter into without tax motives. The Tax Court noted that the taxpayer incurred significant costs to convert cash into illiquid investments, and then back into 80% cash and 20% LIBOR notes, when the taxpayer could have simply used 20% of the cash to purchase LIBOR notes. Because no reasonable business person would have entered into such a transaction absent tax motives, the transaction lacked economic substance.

Thus, like the Tax Court in Sheldon, the Tax Court in Saba warned that modest profit potential may not be sufficient to give a transaction economic substance. However, the Tax Court did not hold that economic substance requires that a transaction generate profit in excess of the tax benefits, nor did it attempt to define any sort of objective

¹⁷⁶ *Id.* (emphasis added).

¹⁷⁷ 861 F.2d 494, 499 (7th Cir. 1988).

Page 82
 «M_1Investor»
 December 31, 1999

standard for determining whether a profit potential is sufficient. It merely held that, where the transaction at issue is one in which no person would enter into without the tax benefits, a small profit potential will not imbue a transaction with economic substance.

The facts in the instant case can be distinguished from ASA and Saba in that a profit motive existed for Investor and Presidio in entering into Partnership, and a valid partnership was formed. The pooling of the partners' assets to manage a substantial amount of property is a valid reason to use a partnership, and need not be conducted through a corporation.¹⁷⁸ The investment vehicle chosen by Presidio was a limited liability company treated as a partnership for U.S. income tax purposes. Both Presidio and Investor contributed funds to Partnership pursuant to the Limited Liability Company Agreement. All investments, disbursements, and ongoing activities, including maintenance of capital accounts, are required under the LLC Agreement to be accounted for under generally accepted accounting principles. Unlike the lender relationship described in ASA, Presidio will share in partnership profits during the term of the partnership, will receive the amount of its capital account upon liquidation of Partnership, and will be fully subject to the risks of Partnership investments.

Furthermore, unlike the transactions in Saba, the debt undertaken by Investor and the investments by the Partnership in foreign currency are transactions that are entered into by people without a tax motive. Thus, the Tax Court's admonition in Saba that a modest profit potential in a transaction is insufficient, where no person would enter into the transaction absent the tax consequences, is inapplicable in the instant situation. Therefore, the economic substance doctrine as formulated by ACM Partnership, *supra*, in which the Third Circuit merely determined whether the transaction at issue objectively affected the taxpayer's net economic position, legal relations, or non-tax business interests, and did not make an inquiry as to the degree of economic profit potential that is required, should be applied. Since Investor had a reasonable opportunity to earn a reasonable pre-tax profit from the transactions, we believe it is more likely than not that the economic substance prong is satisfied by Investor.

Finally, the Tax Court has recently addressed the business purpose and economic substance doctrine in three different cases. In Winn-Dixie Stores v. Commissioner,¹⁷⁹ the Tax Court applied the ACM Partnership analysis and held that interest expense

¹⁷⁸ See Chisholm v. Commissioner, 79 F.2d 14 (2nd Cir.), *cert. denied*, 296 U.S. 641 (1935).

¹⁷⁹ 113 T.C. No. 21 (10/19/99).

incurred by Winn-Dixie on a corporate-owned life insurance (COLI) program was not deductible because the program lacked both economic substance and a business purpose.

Winn-Dixie used a "zero-cash" strategy to purchase life insurance on all of its employees with borrowed funds. The insurance carrier charged a high rate of interest, but credited Winn-Dixie with a high rate of return, with a 40 basis point spread (in favor of the insurance carrier). The pre-tax cost of the COLI program -- calculated by subtracting the annual premium, loan interest and administration fees from the cash surrender value plus the death benefits -- ranged from approximately \$4.6 million in the first year of the program to over \$18 million in later years of the program. The projected pre-tax loss for the life of the COLI program was slightly more than \$750 million. The projected tax benefit of the program, on the other hand, achieved by deducting the interest as interest expense, was more than \$3 billion. Thus, the COLI program only made economic sense when the tax savings were considered. As a result, the Tax Court held that the COLI program lacked economic substance.

Additionally, the Tax Court held that the COLI program lacked a business purpose. The taxpayer claimed that "savings" from the COLI program allowed it to fund its other benefits obligations. However, since the "savings" from the COLI program were solely tax savings, the Tax Court held that the COLI program's sole purpose was to generate tax deductions. The Tax Court also rejected the other claimed business purposes of the COLI program, noting that the taxpayer terminated the COLI program after a tax law change that prohibited the deduction of policy loan interest under the program, thereby calling into question the taxpayer's purported business purposes. Thus, the Tax Court declared the COLI program a sham, and held that Winn Dixie was not entitled to deduct its interest expense.

Similarly, the Tax Court applied the economic substance and business purpose doctrine in Compaq v. Commissioner¹⁸⁰ to disallow a foreign tax credit claimed by Compaq. In Compaq, the taxpayer designed and prearranged a transaction whereby it purchased, and immediately resold, American Depositary Receipts (ADRs) of a foreign corporation on the floor of the NYSE. As a result of the transaction, the taxpayer was the shareholder of record of 10 million ADRs on the dividend record date. The taxpayer received a dividend of \$22,545,800, less withheld foreign taxes of \$3,381,870. As a result of the dividend, the ADRs decreased in value, so on the resale of the ADRs, the taxpayer

¹⁸⁰ 113 T.C. No. 17 (9/21/99).

Page 84
 «M_Investor»
 December 31, 1999

recognized a \$20,652,816 capital loss, which was offset against previously realized capital gains. The net cash flow from the transaction, without regard to tax consequences, was a \$1,486,755 loss.

The Tax Court found that this transaction was predetermined and designed by the taxpayer to yield a specific result and eliminate all market risks. The Tax Court noted that the taxpayer virtually eliminated the risk of price fluctuation through use of predetermined purchase and resale prices, and through the execution of almost simultaneous purchase and resale cross-trades. The taxpayer also used special next-day settlement terms and large blocks of ADRs to eliminate the risk of third parties breaking up the trades. Furthermore, the Tax Court held that the taxpayer had no reasonable possibility of a profit from the ADR transaction without its anticipated federal income tax consequences. The transaction thus operated as "an integrated package, designed to produce an economic gain when—and only when—the foreign tax credit was claimed."¹⁸¹ Accordingly, the Tax Court found that the transaction lacked economic substance and operated as a mere tax artifice.

The Tax Court also held that the taxpayer had no business purpose for the purchase and sale of ADRs apart from obtaining a federal income tax benefit. The Tax Court noted that the ADR transaction was marketed to the taxpayer for the purpose of partially shielding a previously realized capital gain, and that the taxpayer committed itself to a questionable multi-million dollar transaction without thoroughly considering and analyzing its economic ramifications. Thus, the taxpayer failed both the economic substance and business purpose inquiries, and the foreign tax credit it claimed was disallowed.

Finally, the Tax Court applied the economic substance and business purpose doctrine in United Parcel Service of America v. Commissioner¹⁸² to find the taxpayer liable for taxes on income that it attempted to divert to another entity. UPS charged shippers 25 cents for parcels with a declared value of over \$100 as an "excess value charge" (EVC). These payments were used to offset its risks associated with liability for its shipping losses. In 1983, UPS restructured its EVC activity, and created OPL, an overseas insurance subsidiary. UPS continued performing the same EVC services and activities after the restructuring, but began transferring excess value revenues to OPL, and did not report these revenues as income for federal income tax purposes.

¹⁸¹ 113 T.C. No. 17, 19.

¹⁸² 77 T.C.M. (CCH) 2030 (1999).

Page 85
«M_Investor»
December 31, 1999

The Tax Court held that the EVC restructuring was driven by expected tax benefits for the UPS and OPL common shareholders, and that no other business purpose existed. The restructuring was not, as UPS alleged, motivated by a good faith concern that UPS was violating state or Federal insurance laws by collecting excess value revenues. Nor did UPS shift excess value revenues to OPL to justify raising its shipping rates. Furthermore, the EVC restructuring did not transfer or reduce UPS's liability to shippers in any meaningful sense.

The Tax Court further held that UPS's arrangement with OPL lacked economic substance. The restructuring did not significantly reduce UPS's financial exposure, so as to provide a nontax benefit to UPS. The Tax Court also asserted that the absence of arm's length price negotiations between UPS and OPL, as well as the relationship between price coverage and fair market value, suggest that the arrangement was a sham. Finally, contemporaneous documentation established that UPS seriously considered, and was motivated by, the reduction of federal income tax that would occur after the restructuring. In contrast, no such documentation, such as corporate minutes, substantiated UPS's nontax business reasons for the restructuring.

In summary, the case law applying the business purpose/economic substance doctrine consistently require that the following factors be satisfied:

- Either the transactions entered into by an investor must have inherent economic risks where there is the potential for gain or loss and the investor must be able to demonstrate a reasonable potential for making a pre-tax profit, or the transactions must have some subjective non-tax business purpose; and
- In determining whether there is a potential profit, unrelated transactions should not be taken into account.

Based upon Investor's representation that Investor independently reviewed the economics underlying the Investment Fund before entering into the program and believed there was a reasonable opportunity to earn a reasonable pre-tax profit from the transactions undertaken, the first requisite is satisfied. Based upon Presidio's description of the Investment Fund, the profit from the Investment Fund arises from an integrated investment strategy. Accordingly, there are no unrelated transactions providing incremental profit potential.

In addition to the requisite profit motive for entering into the investment strategy, the Service could challenge Investor's business purpose for the structuring of its financing to participate in the Investment Fund. As discussed, the Tax Court in ACM Partnership stated that "the transaction must be rationally related to a useful nontax purpose that is plausible in light of the taxpayer's conduct and useful in light of the taxpayer's economic situation and intentions. Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry."¹⁸³ The court observed that a rational relationship will ordinarily not be found unless the taxpayer had a reasonable expectation that the nontax benefits of the transaction would at least equal the transaction costs.

As noted, to participate in the Investment Fund, Investor was required to commit a sufficient level of funding to the program so as to afford the Managing Member with the capital to act upon extraordinary market opportunities. The «M_4Loan_Amount» loan was integral to Investor's financing structure in that the use of the premium loan arrangement resulted in an integrated investment strategy whereby there was complementary levels of investment risks and financing risks at all times during the term of the Investment Fund. By having the loan premium, it was possible to match the investment risks with the financing risks. Investor entered into the «M_4Loan_Amount» loan in its individual capacity and then contributed the loan proceeds and additional cash to Partnership. By leveraging its capital contribution to Partnership outside Partnership, Investor was able to guarantee a minimum initial amount of financial leverage. This leveraging effect is especially important during the first two stages of the Investment Fund where investment returns are premised upon investments in low and moderate risks positions. In essence, Investor has an inherently high profit potential on its investment capital even though the investment strategy is relatively conservative in the first two stages.

Whereas the above sets forth the commercial rationale for Investor's choice of financing structure, in assessing economic substance and business purpose, of most importance relative to existing case law is that Investor had the expectation of a pre-tax profit from participating in the Investment Fund that exceeded its financing costs. We believe that it is more likely than not that Investor will satisfy the requisite economic substance/business purpose doctrine with respect to participation in the Investment Fund and as to the financing arrangement utilizing the loan premium structure. Although not

¹⁸³ ACM Partnership, 73 T.C.M. (CCH) 2189 at p.118.

Page 87
 «M_Investor»
 December 31, 1999

consistent with the other cases, Sheldon, *supra*, provides that there must be not only a reasonable chance of making a pre-tax profit, but the reasonably expected pre-tax profit must be greater than de minimis. In the instant transaction, the expectation was that this standard would also be met.

A potentially more difficult issue would arise if the motive to make a pre-tax profit must be greater than the tax benefit sought. Several courts have indicated that they would consider whether the profit motive was greater than the tax motive.¹⁸⁴ However, requiring that the profit motive be primary would be inconsistent with other areas of the tax law that have adopted a more generalized business purpose requirement either judicially (such as in reorganizations) or statutorily (such as Code Section 269).

Notwithstanding that the transactions in the instant case have the requisite economic substance, Code Sections 165(c) and 183, where applicable, impose additional limitations on the ability of individuals to claim deductions for losses. Code Section 165 applies to loss deductions, and Code Section 183 applies to all deductions. If an individual incurs a loss from the disposition of assets in the individual's trade or business or in a transaction entered into for profit, Code Sections 165(c) and 183 generally permit the allowance of such loss.

The regulations under Code Section 165 do not define the meaning of "for profit," whereas the regulations under Code Section 183 do define the phrase. The determination of whether a transaction has been undertaken for profit for purposes of Code Section 183 is based on all the facts and circumstances. Treas. Reg. Section 1.183-2(b) lists nine specific factors that are to be taken into account in making this determination. This regulation also provides that "[a]lthough a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity... with the objective of making a profit."

Code Section 183(a), Treas. Reg. Section 1.183-1, Code Section 165(c)(2) and Treas. Reg. Section 1.165-1(e) all require that individuals incurring a loss from a transaction not involving a trade or business have a profit motive. Thus, these two statutes and regulatory provisions parallel each other. Notwithstanding the literal language of Code Sections 165(c)(2) and 183, some courts have imposed a judicial gloss on Code Section

¹⁸⁴ See, e.g., Fox v. Commissioner, 82 T.C. 1001 (1984) and Estate of Baron v. Commissioner, 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986).

Page 88
 «M_Investor»
 December 31, 1999

165(c)(2), and to some extent on Code Section 183(a), by ruling that the taxpayer's *primary* motive must be to generate pre-tax profits from the activity.¹⁸⁵

In Fox v. Commissioner,¹⁸⁶ the Tax Court based its expansion of the language of the statute on dictum found in Helvering v. National Grocery Co.,¹⁸⁷ an accumulated earnings case. The Tax Court's reasoning in Fox seems questionable as there is little in the National Grocery decision to support the Tax Court's contention that the Supreme Court intended to change the meaning of Code Section 165(c)(2) in this way. The Court in Fox also based its decision on an earlier Code Section 165(c)(2) case, Smith v. Commissioner.¹⁸⁸ In Smith, however, the Tax Court did not impose the "primary" test articulated in Fox, but rather stated:

The mere fact that petitioners may have had a strong tax avoidance motive in entering into their commodity tax straddles does not in itself result in a disallowance of petitioner's losses under Code Section 165(c)(2), provided petitioners also had a non-tax profit motive for their investments at the time. Knetsch v. United States, 348 F.2d 932 (Ct. Cl. 1965). Such hope of deriving an economic profit aside from the tax benefits need not be reasonable so long as it is bona fide. Bessenvey v. Commissioner, 45 T.C. 261 (1965), *aff'd*, 1379 F.2d 252 (2d. Cir. 1967).¹⁸⁹

Much of the confusion that arises in this area results from misreadings of dicta and former courts' findings. Originally, the term "primarily" was a notion developed to determine how a mixed personal-profit transaction was to be characterized and not how a commercial transaction was to be treated.¹⁹⁰ As illustrated by the multitude of decided cases, no single, uniform standard exists for applying the primary profit motive test. This lack of uniformity can be attributed in part to the varying language and standards used by the courts to identify and apply the primary test. Additionally, the courts' failure to explicitly indicate the method used to compare a taxpayer's various objectives exacerbates the confusion surrounding the application of the primary test.

¹⁸⁵ See, e.g., Fox v. Commissioner, 82 T.C. 1001 (1984).

¹⁸⁶ 82 T.C. 1001 (1984).

¹⁸⁷ 304 U.S. 282, 289 n.5 (1938).

¹⁸⁸ 78 T.C. 350 (1982), *aff'd*, 820 F.2d 1220 (4th Cir. 1987).

¹⁸⁹ Smith, 78 T.C. at 391.

¹⁹⁰ See Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962).

Page 89
 «M_Investor»
 December 31, 1999

Judge Swift of the U.S. Tax Court discussed the proposition that the primary profit motive test has not been developed uniformly by the courts in his concurring opinion in Peat Oil & Gas Assocs. v. Commissioner.¹⁹¹ In this case, Judge Swift noted:

The courts have not been consistent in the language used to describe the quantity or level of profit objective that must be established. The inconsistent profit-objective language that has been used has included, among other language, the following: "Basic," "dominant," "primary," "predominant," "substantial," "reasonable," "bona fide," and "actual and honest." As one court commented, we have been glutted with tests. Many such tests proliferate because they give the comforting illusion of consistency and precision. They often obscure rather than clarify.¹⁹²

Both the Fox and Smith cases, as well as the bulk of subsequent cases involving the "primary" profit motive standard under Code Section 165(c)(2), arose in connection with commodities straddle transactions in which, looking at the transactions as a whole, the taxpayer had little or no opportunity to earn any meaningful profit. On the other hand, we are not aware of any cases applying the "primary" profit motive standard under Code Section 165(c)(2) involving taxpayers who had some meaningful profit motive or potential. Accordingly, the Code Section 165(c)(2) cases go into little detail in analyzing the degree of profit motive required where both a profit motive and non-profit motives exist. Such cases merely reiterate the primary profit motive standard, and hold that since only non-profit, tax motives exist, the profit motive requirement of Code Section 165(c)(2) is not met. Some cases under Code Section 183, on the other hand, do engage in an analysis of weighing profit motives against non-profit motives. Since Code Section 183 contains nearly identical language as Code Section 165(c)(2), the case law decided under Code Section 183 is instructive in interpreting Code Section 165(c)(2).

One such case under Code Section 183 is Estate of Baron v. Commissioner.¹⁹³ In Baron, the Tax Court rejected the primary profit motive test and used an "intermediate" test in

¹⁹¹ 100 T.C. 271 (1993).

¹⁹² Peat Oil, 100 T.C. at 280. For a further discussion of the lack of uniform language used by courts to describe the primary test, see Rose v. Commissioner, 88 T.C. 411-14 (1987), discussing different words used to describe the profit objective test; and Johnson v. United States, 11 Cl. Ct. 17 (1986), discussing various profit objective tests applied by the Tax Court.

¹⁹³ 83 T.C. 542 (1984), *aff'd*, 798 F.2d 65 (2d Cir. 1986).

Page 90
 «M_Investor»
 December 31, 1999

which it balanced profit against tax benefits. This test required a weighing “in the context of all the factors involved in determining the existence of the requisite profit objective, rather than applying a ‘primary or dominant’ test for nontax factors ... or a sole objective test for the tax benefits.”¹⁹⁴ In Baron, the Tax Court looked at the taxpayer’s profit potential under the more optimistic profit projections given the taxpayer at the time of the transaction, and determined that such profit potential was insignificant when compared to the tax savings and the taxpayer’s overall lack of interest in the transaction. Accordingly, the Tax Court held that the taxpayer did not have an adequate profit motive under Code Section 183.

The Court of Claims subsequently offered yet another view of the profit motive test in Johnson v. United States.¹⁹⁵ Johnson involved a wrap lease of computer equipment, in which the taxpayer had both tax and profit motives for entering into the lease. It rejected the primary profit motive test, stating that such test only applies in the hobby-loss area, and not to business losses. The court held that a taxpayer satisfies the profit motive requirement if, at the time of the transaction, the taxpayer had a reasonable expectation of making a reasonable pre-tax profit. Applying this test, the Court of Claims held that the taxpayer therein had such a reasonable expectation, rejecting the Service’s argument that the profit expectation of 6 percent was too low. The Court explicitly stated that tax motives were irrelevant – the sole question was whether the taxpayer, in fact, had a profit motive.

As discussed above, Investor had a reasonable expectation of a reasonable pre-tax profit from its investments. Since Investor had a profit motive and a reasonable expectation of profit, the analysis of the Tax Court in Baron and the Court of Claims in Johnson is more on point to the instant situation than Fox and its progeny, which involved straddle cases in which the potential for economic profit was minimal or non-existent. Thus, we believe the better argument is that the “primarily for profit” test articulated in Fox will not apply where the taxpayer is motivated at least in part by profit potential, and that a test similar to that applied by the Tax Court in Smith (bona fide hope of deriving an economic profit), the Tax Court in Baron (a weighing of all factors, including tax motivations), and the Court of Claims in Johnson (reasonable expectation of a reasonable profit, with tax motivations disregarded) will instead be applied under both Code Sections 165(c)(2) and 183.

¹⁹⁴ Baron, 83 T.C. at 558.

¹⁹⁵ Johnson v. United States, 11 Cl. Ct. 17 (1986).

Page 91
 «M_Investor»
 December 31, 1999

d. Notice 99-59

In Notice 99-59,¹⁹⁶ the Service announced that tax losses generated by a specific investment strategy were not allowable for federal income tax purposes. The arrangement targeted by the IRS typically involves taxpayers who, acting through a partnership, contribute cash to a foreign corporation in exchange for common stock. Another party contributes additional capital to the corporation in exchange for preferred stock. The foreign corporation then borrows additional capital from a bank and gives the bank a security interest in securities that equals the value of the loan. The foreign corporation then distributes the encumbered securities to the partnership. As a result of that distribution and other fees and transaction costs, the remaining value of the common stock is reduced to zero or a minimal amount.

Sometime later, the foreign corporation, as agreed by the parties, repays the bank debt with other corporate assets. Although the parties previously treated the debt as reducing the amount of the earlier distribution, according to the notice promoters of this strategy advised investors to take the position that the foreign corporation's repayment of the debt is not a distribution of its common stock.

The Service contends in Notice 99-59 that the losses generated by this arrangement (or any similar arrangement) lack economic substance under ACM Partnership, *supra*. According to the Service, through a series of contrived steps, taxpayers claim tax losses for capital outlays that they have in fact recovered. Also according to the Service, such artificial allowances are not allowable for federal income tax purposes. Also, in the view of the Service, the purported benefits from the transactions "may also be subject to challenge under the provisions of the Code and regulations, including, but not limited to sections 269, 301, 331, 446, 475, 482, 752, and 1001 of the Code."

The Service also cites Scully v. United States, 840 F.2d 478, 486 (7th Cir. 1987) (to be deductible, a loss must be a "genuine economic loss"), and Shoenberg v. Commissioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"). In Scully, the Seventh Circuit held that there was no deductible loss involving the sale of real estate by trustees of the family trust to other family trusts with the same fiduciaries, beneficiaries and remaindermen. The disposition merely resulted in a reshuffling of assets which resulted in no "genuine economic loss" because the taxpayer retained

¹⁹⁶ 1999-52 I.R.B. 761

Page 92
 «M_Investor»
 December 31, 1999

control over the property – i.e., the sale was effectively a circular transaction with no economic substance. Citing from 7 J. Mertens, Law of Federal Income Taxation § 28.26 (1980), the Court relied upon the following principle for its conclusion that the loss incurred on the sale of the real estate was not deductible:

Losses will not be allowed which are claimed in connection with transactions which do not vary control or change the flow of economic benefits. . . .

[A taxpayer] will not be permitted to transfer assets from one pocket to another and take a loss thereby where he remains at the conclusion of the transfer the real owner of the property, either because of retention of title, command over the property, either directly or through the person who appears as the nominal vendee or transferee.

In the instant situation, Investor did not continue to own, beneficially or otherwise, the asset the disposition of which generated a loss. Thus, the above stated principle and, therefore, the reasoning set forth in Scully for denying a loss deduction, are not applicable to the subject transaction.

In Shoenberg, the Eighth Circuit held that there was no deductible loss where an investor sold stock at a loss and on the same day bought the same number of identical shares through his investment company. A little more than thirty days later, the investor purchased the shares from his investment company at a lower price than that for which he had originally sold them. The Eighth Circuit denied the investor's loss deduction, stating that "where such sale is made as part of a plan whereby substantially identical property is to be reacquired and that plan is carried out, the realization of loss is not genuine and substantial; it is not real." Economically, the transaction was again a circular transaction with no economic substance. Shoenberg, like Scully, is a case in which the court held that a loss was not realized by the taxpayer because the taxpayer held the same beneficial interest in the purportedly sold assets both before and after the sales. As previously stated, in the instant situation, Investor did not continue to own, beneficially or otherwise, the asset the disposition of which resulted in a loss. Accordingly, the reasoning set forth in Shoenberg for denying a loss deduction also is not applicable to the subject transaction.

Proprietary Material
 Confidentiality Requested

KPMG 0000488H

Page 93
 «M_1Investor»
 December 31, 1999

Furthermore, we have concluded above that the transactions entered into by Investor do not lack economic substance under ACM. Finally, the Code sections cited in Notice 99-59 are specific to the investment strategy described therein.¹⁹⁷ Accordingly, Notice 99-59 does not change our opinion that it is more likely than not that Investor's participation in the Investment Fund satisfies the economic substance doctrine and the requirements for deducting a loss under Code Section 165(c)(2).

IV. Conclusion

Based on and subject to the facts, documentation and representations described and our discussion, and our analysis of the relevant statutory provisions and judicial doctrines, we believe that, under current U.S. income tax law, there is a greater than 50 percent likelihood (i.e., it is "more likely than not") that the following positions will be upheld if challenged by the Internal Revenue Service:

- The «M_7Premium» loan premium will not constitute a liability of Investor or Partnership for purposes of Code Section 752, but represents an addition to the «M_4Loan_Amount» loan to be amortized under Treas. Reg. Section 1.163-13 against the issuer's interest expense over the life of the loan;
- Investor will recognize no gain or loss upon receipt of the loan proceeds of «M_4Loan_Amount», including the loan premium of «M_7Premium»;
- Investor will be recognized as the true borrower of the loan for U.S. federal income tax purposes;
- Investor will recognize no gain or loss with respect to its capital contribution of «M_9Cls_A_Contribution» to Partnership subject to the «M_4Loan_Amount» loan;
- The fixed rate debt instrument and interest rate swap will not be integrated under Treas. Reg. Section 1.1275-6(c)(2);

¹⁹⁷ In any event, the applicability of the relevant Code sections to Investor's participation in the Investment Fund is considered throughout this opinion letter.

Page 94
 «M_1Investor»
 December 31, 1999

- Upon the redemption of Investor's Partnership interest, Investor's adjusted basis of «M_16Premium__Cash»¹⁹⁸, plus or minus its allocable share of Partnership income or loss in Partnership, is reduced by actual cash received of «M_17Cash_Distributed». The difference is a capital loss deductible under Code Section 165(a), and subject to Code Section 165(f) which provides that losses from sales or exchanges of capital assets are allowed only to the extent allowed in Code Sections 1211 and 1212;
- Investor's sole member's Code Section 465 "at risk" amount for its taxable year ending on December 31, 1999, will include its net cash contribution to Partnership, less Investor's portion of Partnership's nonrecourse liability, plus or minus its allocable share of Partnership income or loss;
- Partnership income (or loss) and the loss upon the redemption of Investor's interest in Partnership will not be subject to limitation under the Code Section 469 passive activity loss rules;
- Investor's issuance of the debt instrument will not have a substantial effect on the issuer's U.S. income tax liability that could be construed as unreasonable in light of the purposes of Code Sections 163(e), 1271 through 1275, or 701-777.

Our conclusions are based on the completeness and accuracy of the above-stated facts, representations and assumptions. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, and the judicial and administrative interpretations thereof, all as in effect as of the date of this letter. These authorities are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless separately engaged to do so in writing, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

Very truly yours,

¹⁹⁸ See Footnote 13.

3467

Page 95
«M_1Investor»
December 31, 1999

KPMG LLP

RSB: rsb

Proprietary Material
Confidentiality Requested

KPMG 0000488K

Watson, Mark T

From: Wiesner, Philip J
 Sent: Monday, May 10, 1999 8:52 AM
 To: Rosenthal, Steven M
 Cc: Springer, Mark A; Smith, Richard H (WNT); Watson, Mark T; Lippman, Michael H
 Subject: RE: Who is the Borrower in the BLIPS transaction

Gentlemen: Please help me on this. Over the weekend while thinking about WNT involvement in BLIPS I was under the impression that we had sent the transaction forward to DPP Tax on the basis that everyone had signed off on their respective technical issue(s) and that I had signed off on the overall more likely than not opinion. If this impression is correct, why are we revisiting the opinion other than to beef up the technical discussion and further refine the representations on which the conclusions are based. I am very troubled that at this late date the issue is apparently being revisited and if I understand correctly, a prior decision changed on this technical issue?! Richard, in particular, jog my memory on this matter since I based my overall opinion on the fact that everyone had signed off on their respective areas?

Phil

-----Original Message-----

From: Rosenthal, Steven M
 Sent: Friday, May 07, 1999 4:48 PM
 To: Wiesner, Philip J
 Cc: Springer, Mark A; Smith, Richard H (WNT); Watson, Mark T
 Subject: Who is the Borrower in the BLIPS transaction

Phil,

As a follow-up to our meeting this morning, I wanted to outline my concerns on the "Who is the Borrower" issuer. My research suggests that this question turns on economic substance--and a "facts and circumstances" determination. My largest concern is that the BLIPS facts suggest that, in economic substance, the partnership, rather than the individual investor is the true borrower (assuming there is a debt). I believe the following facts are problematic: the investor is nominally the borrower for only a transitory period (7-10 days); the loan is non-recourse (the investor never assumes any personal liability); the investor does not control the proceeds (the proceeds are left in the bank) and the investor apparently has little investment discretion while it holds the funds; the investor presumably will earn a negative spread while it holds the proceeds; the bank--and all of the other parties to the transaction-- will look to the partnership, and not the investor, to repay the loan; the non-tax business reason for the investor to borrow the proceeds and convey the loan is not substantial (the purported reason, leverage, can be accomplished in or out of the partnership).

The case law (Plantation Patterns, NIPSCO, Aiken) emphasizes that the substance (which requires a non-tax business purpose), and not the form, of an arrangement is critical to answering the question of "Who is the Borrower." Thus, in NIPSCO, a back-to-back finance arrangement that provided the intermediary with dominion and control of the funds and a positive interest rate spread was upheld, but, in Aiken, an intermediary that earned no profit was not respected.

The S-corporation cases appear of limited value. In these cases, the individual actually borrows and enters into another loan agreement (and thereby remains liable on the original loan). In our case, the individual borrows and then conveys the assumed loan to the partnership (without a substantial change in its economic position). In addition, in these S corporation cases, the bank typically was unaware (and did not care) that the loan proceeds were relent (see, e.g., Bolding). In BLIPS, the bank (and the other parties) contemplate that the partnership, and not the investor, will repay the loan. Likewise, in Rev. Rul. 80-240, in a structure very similar to BLIPs (but, with a corporation and not a partnership, assuming a loan borrowed by an individual), the IRS determined that the individual would be ignored for federal income tax purposes because the individual was merely an intermediate agent (and there was no plan or intention for the individual either to own the property acquired with the loan proceeds or repay the loan proceeds).

Even if we could surmount these first two issues (i.e., a non-tax business purpose and the requirement that the parties look to the investor as the borrower), there are further hurdles to relying on these S-corporation cases. In *Bergman v. U.S.* (decided last month by the 8th Cir.), the court emphasized that "[l]oan transactions, like all transactions, must have independent economic substance to confer tax benefits on the parties [citations omitted]. The tax benefits of creating indebtedness thus may be set aside if the taxpayer's economic situation has not actually changed [citations omitted]. Actual indebtedness is created only where there is an economically significant change in the taxpayer's wealth; in other words, there must be an actual economic outlay that leaves the taxpayer poorer in a material sense [citations omitted]." In a non-recourse situation, like BLIPS, the investor appears no poorer, or at more risk, by serving as an intermediary, as compared to his exposure if the partnership had borrowed the proceeds directly.

Steve

MTW 0031

MTW 0032

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 98

Watson, Mark T

From: Lanning, John T
 Sent: Monday, May 10, 1999 6:02 PM
 To: Wiesner, Philip J; Ammerman, Douglas K
 Cc: Stein, Jeff; Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
 Subject: RE: BLIPS

Phil:

Thanks for the message - you've framed the issues well.

All:

So who's court is the ball in now?

John

-----Original Message-----
 From: Wiesner, Philip J
 Sent: Monday, May 10, 1999 9:51 AM
 To: Lanning, John T; Ammerman, Douglas K
 Cc: Stein, Jeff; Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
 Subject: RE: BLIPS

John/Doug: Many people have worked long and hard to craft a tax opinion in the BLIPS transaction that satisfies the more likely than not standard. I believed that we in WNT had completed our work a month ago when we forwarded the opinion to Larry. Based on my attendance at numerous technical meetings and my reading the opinion, I came to the conclusion that we could reach an overall more likely than not tax opinion based on the information provided re business purpose and potential profit and the representations to be provided by the investor and Presidio. We viewed our role as a positive one, ie, we would work very hard to achieve, if possible, the desired level of opinion and suggest improvements, in particular, to limit the risks which the Firm is assuming by issuing the opinion.

The speed to market issue is also troubling to me, but perhaps for different reasons. First, this is a classic transaction where we can labor over the technical concerns, but the ultimate resolution - if challenged by the IRS - will be based on the facts (or lack thereof). In short, our opinion is only as good as the factual representations that it is based upon. As the courts did in the individual tax shelter cases of the 80s and in the recent ACM case, the decision will be based not on the technical niceties, but on the overall issues of whether in fact the investors approached the transaction from a business like point of view with a real desire to make a profit other than from tax benefits. Second, we have been dealing with a true prototype opinion where the facts keep evolving. The real "rubber meets the road" will happen when the transaction is sold to investors, what the investors' actual motive for investing the transaction is and how the transaction actually unfolds. Our opinion will be worth little (but we will be protected from risk if it is properly caveated) is the actual facts bear little relation to the assumed facts in the opinion. Note: This is Mark Watson's primary concern based on the recent Presidio discussions at a PFP meeting. Third, our reputation will be used to market the transaction. This is a given in these types of deals. Thus, we need to be concerned about who we are getting in bed with here. In particular, do we believe that Presidio has the integrity to sell the deal on the facts and representations that we have written our opinion on? We have had past experience in the foreign stock redemption and the OPUS transactions which shows how difficult it is to keep the facts in line. Thus, the process has been slowed by a number of very critical forces which have been at work.

Having said all the above, I do believe the time has come to shit and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles (Yes, in my opinion), has the engagement letter been drafted with the right risk limiting language (from what I have seen, Yes) and is the marketing of the transaction limited to very sophisticated taxpayers who are made aware of the risk and properly advised by their own tax and investment advisers (I thought that the marketing here was to be limited to a very small and narrow range of risk taking individuals!) and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? If the answers are yes to both questions, then we have done all we can do from a technical point of view and it is time to move on and decide the business case. My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as failing squarely within the tax shelter orbit. Finally, as I said above, our opinion is only as good as the underlying factual assumptions and actions by the investors. We cannot control with any certainty what they will do in fact!

The way forward. In my view, the technical issues have been worked about as well as they can be. We should decide as a business matter to proceed and work to have in place controls to make sure that the sellers of the transaction and the investors in the transaction do not make a sham of our opinion.

Phil

-----Original Message-----

From: Lanning, John T
Sent: Saturday, May 08, 1999 3:32 PM
To: Ammerman, Douglas K; Wiesner, Philip J
Cc: Stein, Jeff; Lippman, Michael H
Subject: FW: BLIPS

I must say that I am amazed that at this late date (must now be six months into this process) our chief WNT PFP technical expert has reached this conclusion. I would have thought Mark would have been involved on the ground floor of this process, especially on an issue as critical as profit motive. What gives? This appears to be the antithesis of "speed to market". Is there any chance of ever getting this product off the launching pad, or should we simply give up???

John

-----Original Message-----

From: DeLap, Larry
Sent: Friday, May 07, 1999 7:48 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S
Cc: John Lanning; Jeff Stein
Subject: FW: BLIPS

Doug, Jeff, and Randy -

Steve Rosenthal informed me on Tuesday afternoon that he had substantial concern with the "who is the borrower" issuer, and that he would be discussing the matter with Randy on Tuesday or Wednesday. I don't know what the outcome of those discussions were. I imagine Steve would have a concern with the second bullet in Mark Watson's message.

I don't believe a PFP product should be approved when the top PFP technical partner in WNT believes it should not be approved.

I will be back in the U.S. on Saturday and in the Silicon Valley office on Monday morning. Please give me a call on Saturday afternoon or Sunday at home (408-353-3309) or on Monday morning in the office.

Larry

-----Original Message-----

From: Watson, Mark T
Sent: Wednesday, May 05, 1999 9:21 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S
Subject: BLIPS

Based on our meeting on April 30 and May 1, I am *not* comfortable with the BLIPS product for the following reasons:

- According to Presidio, the probability of making a profit from this strategy is remote (possible, but remote). Thus, I don't think a client's representation that they thought there was a reasonable opportunity to make a profit is a reasonable representation. If it isn't a reasonable representation, our opinion letter is worthless.
- The bank will control, via a veto power over Presidio, how the "loan" proceeds are invested. Also, it appears that the bank will require this "loan" to be repaid in a relatively short period of time (e.g., 60 days) even though it is structured as a seven-year loan. These factors make it difficult for me to conclude that a bona fide loan was ever made. If a bona-fide loan was not made, the whole transaction falls apart.

Until these issues are resolved satisfactorily, I don't think we should release this product.

3471

Mark T. Watson
Partner
KPMG - Washington National Tax
202-467-2433 (phone)
202-822-8887 (fax)

Sequential

From: Stein, Jeff [jstein@KPMG.com]
 Sent: Wednesday, May 12, 1999 1:30 AM
 To: DeLap, Larry; Lanning, John T
 Subject: RE: BLIPS Update

Sensitivity: Private

Yikes!

> -----Original Message-----
 > From: DeLap, Larry
 > Sent: Tuesday, May 11, 1999 11:50 PM
 > To: Lanning, John T
 > Cc: Stein, Jeff
 > Subject: FW: BLIPS Update
 > Importance: High
 > Sensitivity: Private
 >
 > John -
 >
 > Let's discuss, in person on Wednesday if there is time, or by telephone on
 > Thursday.
 >
 > Larry
 >
 > -----Original Message-----
 > From: Watson, Mark T
 > Sent: Tuesday, May 11, 1999 6:39 PM
 > To: DeLap, Larry
 > Subject: RE: BLIPS Update
 >
 > Larry, I don't like this product and would prefer not to be associated
 > with it. However, if the additional representations I sent to Randy on
 > May 9 and May 10 are in fact made, based on Phil Wiesner's and Richard
 > Smith's input, I can reluctantly live with a more-likely-than-not opinion
 > being issued for the product.
 >
 > -----Original Message-----
 > From: DeLap, Larry
 > Sent: Monday, May 10, 1999 11:19 PM
 > To: Mark Watson
 > Subject: FW: BLIPS Update
 >
 > It's not entirely clear to me what this means. The essential
 > question in my mind still is whether you are comfortable with a
 > more-likely-than-not opinion on this product.
 >
 > -----Original Message-----
 > From: Wiesner, Phillip J
 > Sent: Monday, May 10, 1999 5:24 PM
 > To: Lippman, Michael H; DeLap, Larry; Rosenthal, Steven M;
 > Smith, Richard H (WNT); Watson, Mark T
 > Cc: Ammerman, Douglas K; Lanning, John T; Stein, Jeff; Eischeid,
 > Jeffrey A
 > Subject: BLIPS Update
 >
 > The group of Wiesner, R Smith, Watson and Rosenthal met this
 > afternoon to bring closure to the remaining technical tax issues
 > concerning the BLIPS transaction. After a thorough discussion of the
 > profit motive and who is the borrower issue, recommendations for
 > additional representations were made (Mark Watson to follow up on with
 > Jeff Eischeid) and the decision by WNT to proceed on a more likely than

Proprietary Material
 Confidentiality Requested

1

KPMG 0011911

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 103

3473

> not basis affirmed. Concern was again expressed that the critical juncture
> will be at the time of the first real tax opinion when the investor, bank
> and Presidio will be asked to sign the appropriate representations.
> Finally, it should be noted that Steve Rosenthal expressed his dissent on
> the who is the investor issue, to wit, "although reasonable people could
> reach an opposite result, he could not reach a more likely than not
> opinion on that issue."
>
>

Proprietary Material
Confidentiality Requested

KPMG 0011912

Watson, Mark T

From: Watson, Mark T
Sent: Thursday, July 22, 1999 9:26 AM
To: Smith, Richard H (WNT); Wiesner, Philip J
Subject: BLIPS -- Economic Substance Issue

Gentlemen, we have completed our review of the BLIPS loan documents. In general, these documents indicate that the loan proceeds will be invested in very safe investments (e.g., money market instruments). Thus, it seems very unlikely that the rate of return on the investments purchased with the loan proceeds will equal or exceed the interest charged on the loan and the fees incurred by the borrower to secure the loan.

The loan documents clarify that it is anticipated that there will be a negative spread on the loan proceeds, and the hope is that the portion of the equity contributed by the client that is invested in foreign currencies -- an amount equal to approximately 5% of the loan premium -- will generate a sufficient rate of return to offset the negative spread on the loan proceeds and the fees charged to enter into the transaction.

For example, assume the client borrows \$100 million dollars at 16% and receives \$150 million from the bank (\$50 million of which represents a premium). Also assume that the \$150 million is invested in instruments that generate a 5% annual rate of return. Thus, on an annual basis *and ignoring fees*, the client pays \$16 million in interest expense (\$100 million x .16) and receives \$7.5 million in interest income (\$150 million x .05). As a result, the client has a negative spread of \$8.5 million before fees.

In an effort to offset this negative spread, the client will invest approximately \$2.5 million (\$50 million x .05) in foreign currencies. Before any fees are considered, the client would have to generate a 240% annual rate of return on the \$2.5 million foreign currencies investment in order to break even. If fees are considered, the necessary rate of return to break even will be even greater.

This example also highlights the issue of how long the client reasonably intends to stay in the partnership/investment. Although the loan is structured as a seven-year loan, the client has a tremendous economic incentive to get out of loan as soon as possible due to the large negative spread.

Before I submit our *non-economic substance* comments on the loan documents to Presidio, I want to confirm that you are still comfortable with the economic substance of this transaction. I have committed to submitting our comments by 3:30 pm on Friday, July 23 (tomorrow).

Also, Richard, have you (or has your designee) had a chance to review the BLIPS LLC agreement I sent to you on July 16?

Assigned - Wells

RECEIVED
DOCKET ROOM
UNITED STATES TAX COURT

U.S. TAX COURT FILED JUN 16 2003
--

03 JUN 16 AM 11:15)
 SCHNEIDER INTERESTS, L.P.)
 BY RUSS SCHNEIDER FARMS, LLC.)
 TAX MATTERS PARTNER, UNITED STATES)
 TAX COURT)
 Petitioner)
)
 v.)
)
 COMMISSIONER OF INTERNAL REVENUE)
)
 Respondent)

Docket No. 200-02
 Honorable Judge Wells

6-13

RESPONDENT'S REQUESTS FOR ADMISSION

Pursuant to Tax Court Rule 90, respondent requests that the petitioner, within 30 days after service of this document, admit the facts set forth in each of the following requests for purposes of the pending action only and subject to all pertinent objections to admissibility which may be interposed at trial. If the petitioner can admit only a part (or a part as qualified) of a particular request for admission, the petitioner should specify so much as is true (or true as qualified) and deny only the remainder of said request. Further, if the petitioner cannot truthfully admit or deny a particular request for admission, the petitioner should state in detail the reasons why this is so.

1. Attached hereto as Exhibit 1 (Bates Stamped 638010-638013) is a true, accurate and authentic copy of a document reflecting an e-mail from Jeff Stein of KPMG dated March 14,

RECORDED	INDEXED
Rm	11
SERIALIZED	FILED
JUN 16 2003	U.S. TAX COURT

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 117

XX-001413

3476

Docket No. 200-02

- 2 -

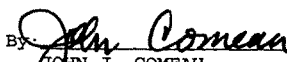
1998 to Gregg W. Ritchie, Douglas J. Green, Robert J. Wells,
John T. Lanning, and Larry DeLap.

PLEASE TAKE NOTICE that pursuant to Tax Court Rule 90, a
written answer to these requests must be filed with the Tax
Court and a copy served on the undersigned within 30 days
after service of these requests for admission.

B. JOHN WILLIAMS, JR.
Chief Counsel
Internal Revenue Service

Date: 6-13-03

By:


JOHN J. COMEAU
Attorney
Tax Court Bar No. CJ0693
200 West Adams Street
Suite 2300
Chicago, Illinois 60606
Telephone: (312) 886-9225

OF COUNSEL:
LINDA BURKE
Division Counsel
(Large and Mid-Size Business)
JAMES C. LANNING
Area Counsel
(Retailers, Food, Pharmaceuticals)
Pamela V. Gibson
(Associate Area Counsel)

-2-

XX-001414

3477

Docket No. 123


CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing
RESPONDENT'S REQUESTS FOR ADMISSION was served on counsel for
petitioner by mailing the same on JUN 13 2003 in a
postage paid wrapper addressed as follows:

N. Jerold Cohen, Esq.
Thomas A. Cullinan, Esq.
Sutherland, Asbill & Brennan, LLP
999 Peachtree Street, NE
Atlanta, GA 30309

Scott G. Miller, Esq.
Broad and Cassel
390 North Orange Ave., Suite 1100
Orlando, FL 32810

Date: JUN 13 2003


JOHN J. COMEAU
Attorney
Tax Court Bar No. CJ0693

new

From: Jeff Stein
 Sent: Saturday, March 14, 1998 6:56 AM
 To: Gregg W. Ritchie; Douglas J. Green; Robert J. Wells; John T. Lanning; Larry DeLap
 Subject: Simon Says

By the way - anybody who does not have a copy of the Pfaff letter, let me know and I will fax it over to you. In addition in case you want a copy of the November 6, 1997 memo detailing the proposed LLC structure written by Simon to "The Working Group" which included Ritchie, Pfaff, Larson, Bickham and R.J. Ruble of the law firm of Brown & Wood let me know and I will fax it over to you as well. As I said below, the OPIS strategy is a stripped down version of the LLC structure.

Incidentally, I failed to mention that the research on the most troublesome issues with respect to this product was done in large measure by Simon, Harris and Margaret Lukes (also IS). Those issues included:

- a - Whether U.S. investor's interest in the Cayman entity was disguised equity.
- b - The application of the at-risk rules and.
- c - The basis of the shares held by the U.S. investor.

Frankly Doug - if you are the ultimate arbiter in this matter, I think you have all the facts you need at your disposal to make your decision. I will have a conversation if you and Greg feel it is necessary but that discussion would only result in a debate over the facts as presented below and Simon and Harris would need to be present on that call to represent what they have told me concerning their involvement in this product.

Guys - Have a terrific weekend.

Forward Header

Subject: Simon Says
 Author: Jeff Stein at KPMG_NYO_Tax2
 Date: 3/14/98 9:46 AM

Bob/John/Larry - I've copied each of you on this because of your involvement up to this point, especially with regard to the technical issues that have arisen, on managing those rare personality flare ups and in coding discussions. I feel (not fear) the end is near.

After some - but not exhaustive - due diligence on my part over the last few days, here is what I was able to come up with as regards the involvement of IS in the OPIS strategy (son of FLIP). They are to be contrasted with Opie and Flipper, two TV characters from the 60's. Obviously reasonable men can differ on both the facts and conclusions but I thought I'd take a stab at laying out at least my understanding which perhaps can serve as a working document for any discussions next week. I invite any of you to please reply and let me know where I am off base on any of this. I have tried to be as honest and accurate as I can be and have toned down my normal pronation (not just a foot and running term Doug) towards exaggeration but have tried to at least add some humor.

638010

XX-001416

EXHIBIT 1

First of all, in terms of involvement you should all have a copy of an unsolicited letter to me from Bob Pfaff extolling the virtues of Bob Simon and which indicates how integrally involved Bob has been in the development of this strategy. From my law school days, I was always told to lead with strength and if you could get a third party to say how great your client was rather than having your client say that he was great - it would better serve you. Thus, Pfaff is my first character witness who may later be called to the stand to discuss specific factual allegations in this case. I believe that letter states that "Bob (Simon) contributed significantly to making it (the basis shift strategy) a better product with less risk for all concerned." So that's Exhibit A.

Just as a matter of background, in September or October of last year Bob Simon and Bob Pfaff began to have discussions on a successor to the FLIP transaction which was being marketed. These discussions took on an air of urgency when Larry Delap determined that KPMG should discontinue marketing the existing product. Simon and Pfaff met in late October and throughout November to tweak or redesign if necessary the old strategy - focusing on the Cayman partnership and adding features designed to lessen any Subpart F or other risks. They determined that whatever the new product, it needed a greater economic risk attached to it and should probably include a debt or convertible debt feature. During those 6 plus weeks, there were daily phone calls between Pfaff and Simon and numerous meetings. The involvement was significant and depending upon which IRS test we want to apply, Simon was big-time involved. Now to the heart of the discussion.

OPIS at it's core (pardon the use of core - it is not a coding term of art) is really just an updated version of the basis shift strategy developed by IS and Pfaff. It is now - and don't take this the wrong way - a watered down version (OBJECTION - OVERRULED) of what Pfaff and Simon came up with in November and which was presented to the IS leadership team by Pfaff in early December for their review and comments. It was Simon who wrote up the product for distribution to the leadership team and for circulation to Larry.

The use of a Cayman partnership instead of a Cayman corp came about through meetings Simon held with Pfaff. Although Pfaff had actually floated that idea back in July when he was still with KPMG, nobody ever pursued it. When FLIP was tabled, Simon brought it back on the table and showed Pfaff how we could achieve an even better structure with a Cayman LLC or partnership. By the way - you guys should feel free to call Pfaff to the stand and ask him to confirm or deny any of what I am saying as well as Simon's involvement.

As you may know, the Cayman entity (in both FLIP and OPIS) is nominally owned by an NRA (nonresident alien). Under the FLIP structure, there was a real question as to whether an NRA was truly an equity holder. In particular, the NRA received a preferred return, was protected from risk, and in most respects looked like a service provider or debt holder. If that were true, either of those characterizations would have lead to a tax disaster. Simon was the one who suggested buttressing the NRA's position as an equity holder and although some of Simon's suggested improvements did not make their way into the ultimate OPIS product, others did. I assume the same could be said of other team members who worked on this product. For example, I know that from discussions with Pfaff, the NRA will now have real economic risk and no longer has a preferred return. In addition, the NRA will hold both equity and debt.

In the FLIP structure, the U.S. investor bought a warrant to purchase 90% of the stock of a Cayman company for a price designed to include all the fees of the participants in the transaction. It was essential

638011

XX-001417

that the warrant be treated as an option to acquire stock in the Cayman company (for Section 302 purposes), without being treated as actual stock. Simon was the one who pointed out the weakness in having the U.S. investor purchase a warrant for a ridiculously high amount of money - well in excess of the strike price - which in no event would be exercised (since the investor also had a cash-settled option which would enable him to gain any upside in the Cayman company without paying the strike price of exercise). It was clear, we needed the option to be treated as an option for Section 302 purposes, and yet in truth the option was really illusory and stood out more like a sore thumb since no one in his right mind would pay such an exorbitant price for such a warrant. Pfaff and Simon discussed alternatives and came up with the idea of having the U.S. investor purchase convertible debt since the investor could be expected to pay at or near the principal amount for convertible debt. Eventually this was changed to a swap (in OPIS) but the idea was the same - to get a bunch (technical term) of money into Cayman corp in a manner which would have some economic substance without itself being equity.

There have been other changes to the strategy as well based on conversations that Simon has had with Pfaff but since Simon was effectively cut out of the loop in mid-December he has not been privy to everything that has transpired.

The FLIP strategy included a loan from a foreign bank to the Cayman company. The Cayman company then turned around and purchased shares in the same bank. Later, the shares were redeemed and magically, at the same moment, the U.S. investor (related to Cayman through the warrant) would buy an option for the equivalent amount of the shares from the Bank. In kicking the tires on FLIP (perhaps too hard for the likes of certain people) Simon discovered that there was a delayed settlement of the loan which then raised the issue of whether the shares could even be deemed to be issued to the Cayman company. Naturally without the shares being issued, they could not later be redeemed. Under OPIS, the same simultaneous redemption is present, BUT settlement of the loan documents will occur immediately, i.e., no delayed settlement. Clearly Simon was very vocal in his concern over the delayed settlement issue and played the key role in eliminating it from the new and improved strategy.

Simon was also the one who suggested and prepared investor's representation letters which dealt primarily with the investor's economic expectations heading into the deal. Prior to that we had some 20 or so representations buried in a 50 page opinion. Because the investor himself was not making the representations, they were of dubious validity. Representation letters will now be issued on all OPIS deals and wherever possible in the old FLIP deals.

Additionally, all of the time spent by John Harris on this project (and it is considerable) has been run through international services contracts. A very significant issue in OPIS is whether the partnership anti-abuse regulations apply. John is the author of that entire section, which was used word for word in the OPIS draft. Incidentally, although admittedly not entirely relevant is the praise that WNT had for that particular section. Indeed, the OPIS draft that Randy Bickham circulated was primarily taken from an earlier draft of a partnership structure that John Harris had worked on with Bob Pfaff before Bob left the Firm.

Finally, and although this may be considered by Greg as an admission against interest, it was Greg who stated in writing to I believe Bob Simon that the "the OPIS product was developed in response to your and DPP tax's concerns over the FLIP strategy. We listened to your input regarding technical concerns with respect to the FLIP product and attempted to work solutions into the new product". I assume Greg does not mean that he worked those technical solutions into the product

638012

XX-001418

himself or with just Mr. Bickham. I will leave the discussion on Mr Bickham and the evaluation of his international technical skills made independently by two senior IS partners to another discussion.

In conclusion - The development of the OPIS strategy was a team effort with the primary technical thrust for the improved product coming from IS. Given the similarity of this product to FLIP and the extensive involvement of Simon and Harris working alongside Pfaff, I do not believe there is any credible claim that PPP invented a new strategy or product called OPIS and it would take an absolute disregard of the facts to reach such a conclusion. As I said above, FLIP is a watered down version of what Simon and Pfaff presented to the IS leadership team in December. I believe that all that has been accomplished over the past two months since Simon has been cut out is that as many of the expensive modifications that could be taken out of OPIS have been and one change has been made, that being the swap rather than the debt instrument (which adds nothing of substance). I also believe that some of the features that gave this product more economic substance have also been eliminated but I will obviously defer to Larry who is the one who should opine on the relevant technical impact of the modifications and eliminations to the product.

What I thought we were trying to achieve here was bringing the best minds we had in this Firm together in order to design the best product to go to market with. That we did and for the five or so months that Simon and Harris have been involved working with Pfaff, not once did anybody ask, including Sandy Smith who is ultimately responsible for the financial results in that geography, who is going to pay IS for the time and effort being spent by the IS group in Denver. That was the same path we went down when Pfaff and Larson worked on the original FLIP strategy. To now say that the hundreds of hours that IS spent in designing this strategy was either nominal or does not rise to the level of substantial is not only offensive but I can guarantee you will not result in a greater sense of teamwork going forward as we attempt to better leverage ourselves with the FCS group.

What I thought we were trying to accomplish in creating that group was not having independent pockets of professionals spending time developing independent strategies that were not nearly as powerful as what we could accomplish working together as a team. That should be what we're trying to accomplish rather than this "mine is bigger than yours" thing that we seem to be experimenting with. Somebody tell me what we're doing here by suggesting a reward system that is based on anything but team. Truth be told on this one, IS has probably been responsible for 80% of the OPIS idea when you examine the final product and compare it to FLIP, along with what led to OPIS, who suggested the key modifications to the FLIP strategy, and the key product characteristics of OPIS. Let's just stay with our 50/50 deal and forget about the Ides of March.

638013

XX-001419

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
 Sent: Friday, March 24, 2000 3:40 PM
 To: Galbreath, Phillip L
 Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H (WNT)
 Subject: RE: S-corp Product

Phil -

Yes, but

it's not officially approved until DPP-Assurance signs off.

Larry

> -----Original Message-----
 > From: Galbreath, Phillip L
 > Sent: Friday, March 24, 2000 12:37 PM
 > To: DeLap, Larry
 > Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H (WNT)
 > Subject: RE: S-corp Product
 >
 > Just want to confirm that we have your approval of this letter if we accept
 > these revisions and change the name of the document.
 >
 > Phillip Galbreath
 > KPMG Tax Innovation Center
 > Phone: 202.533.4162
 > Fax: 202.533.4163
 > MailTo:pgalbrea@kpmg.com
 >
 >
 > -----Original Message-----
 > From: DeLap, Larry
 > Sent: Friday, March 24, 2000 3:14 PM
 > To: Galbreath, Phillip L
 > Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H (WNT)
 > Subject: RE: S-corp Product
 >
 > See two additional revisions attached. Also, should change the title
 > of the document itself.
 >
 > << File: S-CAEPS_ENGAGE.DOC >>
 >
 > -----Original Message-----
 > From: Galbreath, Phillip L
 > Sent: Friday, March 24, 2000 11:37 AM
 > To: DeLap, Larry
 > Cc: Springer, Mark A; Manth, Larry E; Smith, Richard H
 > (WNT)
 > Subject: RE: S-corp Product
 >
 > Attached is the engagement letter revised to reflect these
 > additions and the new name. Please review and provide me with your
 > comments. Thanks.
 >
 > << File: S-CAEPS_ENGAGE.DOC >>
 >
 > Phillip Galbreath
 > KPMG Tax Innovation Center
 > Phone: 202.533.4162
 > Fax: 202.533.4163

1

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 121

KPMG 0046882

3483

> MailTo:pgalbrea@kpmg.com
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Friday, March 24, 2000 12:01 PM
> To: Galbreath, Phillip L
> CC: Springer, Mark A; Manth, Larry E; Smith,
> Richard H (WNT)
> Subject: FW: S-corp Product
>
> On further thought, it seems to me that we need to
> explicitly disclose the downside risk if the IRS disagreed with the
> "second class of stock" arguments.
>
> After the paragraph about the basis of our
> conclusions, I think we should add something like:
>
> The opinions we render will not be binding upon the
> Internal Revenue Service, any other tax authority or any court, and no
> assurance can be given that a position contrary to that expressed therein
> will not be asserted by a tax authority and ultimately sustained by a
> court. In particular, the Internal Revenue Service might argue, and the
> courts might agree, that the non-voting stock constitutes a second class
> of stock, thus invalidating the S corporation election. In that event, the
> corporate earnings would be subjected to tax at the corporate level, and
> distributions to you would be subject to a second level of tax.
> Under "Other Matters", I think we should add
> something like: You acknowledge that you understand the strategy
> involves risk, including the risk of disputes with the section 401(a)
> pension plan concerning valuation or other matters relating to the stock
> contributed to it and the risk of double taxation should the Internal
> Revenue Service successfully maintain that the transaction terminated the
> S corporation election, and that you are prepared to accept those risks.
>
> Larry
>
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Friday, March 24, 2000 7:12 AM
> To: Galbreath, Phillip L
> CC: Springer, Mark A; Manth, Larry E; Smith,
> Richard H (WNT)
> Subject: RE: S-corp Product
>
> << File: S-CAEPS_ENGAGE.DOC >>
>
> See additional revisions attached.
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Thursday, March 23, 2000 3:12 PM
> To: DeLap, Larry
> CC: Springer, Mark A; Manth, Larry E; Smith,
> Richard H (WNT)
> Subject: RE: S-corp Product
>
> Attached is the S-CAEPS engagement letter which has
> been revised to incorporate your comments. Nancy Galib (member of the WNT
> TCS group) reviewed and provided comments which have been incorporated as
> well. Please review and provide me with any additional comments you have.

2

Proprietary Material
Confidentiality Requested

KPMG 0046883

3484

> Thanks.
>
> << File: S-CAEPS_ENGAGE.DOC >>
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbreath@kpmg.com
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Tuesday, March 21, 2000 7:57 PM
> To: Galbreath, Phillip L
> Cc: Springer, Mark A; Manth, Larry E
> Subject: FW: S-corp Product
>
> Phillip -
>
> I think that the engagement letter needs to
> explicitly state that the client needs to engage legal counsel to advise
> on non-tax legal aspects of the transaction and to draft required legal
> documents.
>
> I suggest you have the WNT TCS group look at the
> letter to see if they have any suggestions to add a greater business
> purpose/economic substance concern.
>
> My principal concern lies with how we introduce the
> donee to the client, whether we may have an "alliance" relationship with
> the donee (particularly if a particular donee participates in multiple
> transactions), and whether we should have some sort of written agreement
> with the donee if deemed not to be an alliance. Larry Manth can discuss
> those particular issues with me, but it seems to me the Scope of Services
> should say something about how we help the client select the donee.
>
> In the absence of an ICV, how do we establish the
> fixed fee?
>
> Presumably, a valuation will be needed to establish
> the amount of the charitable contribution. Shouldn't engagement letter say
> something about need for a valuation?
>
> The "restriction on use" language needs to be
> changed from "will not be provided" to "may not be relied upon".
>
> Larry
>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 20, 2000 4:28 PM
> To: DeLap, Larry
> Subject: FW: S-corp Product
>
> Please see messages below. I know you are already
> aware of this strategy and may have already reviewed some of the related
> materials. I received and responded to questions raised by Chris Galer
> (DPP-Assurance) last week. Based on the messages below, Larry Manth will
> be sending the whitepaper and powerpoint presentation directly to you.
> Attached below is the sample engagement letter. Please review and provide
> me with your comments. At this point, there will be no Tax Solution Alert
> or other toolkit documents.
>
> << File: S-CAEPS_ENGAGE.DOC >>
>

3

Proprietary Material
Confidentiality Requested

KPMG 0046884

3485

>
>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com
>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 5:08 PM
> To: Springer, Mark A; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
> Mark and Phillip, I believe that we have sent the
> engagement letter to Larry DeLap. Also, we do not plan on using an ICV
> letter. I believe the only missing item is the powerpoint presentation.
> We are just about complete (I still have not heard from the Southeast
> regarding a product champion). We are working on an updated technical
> write-up covering the assignment of income issues, changing the put
> arrangement (Richard Bailine), and deleting 501(c)(3)'s. Please let me
> know if we are missing anything. Thanks, Larry
>
>
> -----Original Message-----
> From: Springer, Mark A
> Sent: Monday, March 20, 2000 1:37 PM
> To: Manth, Larry E; Galbreath, Phillip L
> Cc: Kelliher, William B; Smith, Richard H (WNT);
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert; Bailine, Richard W
> Subject: RE: S-corp Product
>
> I believe this leaves as the only open item the
> assignment of income issues.
>
> Larry: Assume you are working directly w/ Mark
> Watson.
>
> Philip: Are the other toolkit items (eng letter,
> ICV letter) ready to go to Larry DeLap w/ formal request for review and
> approval to deploy the solution?
>
> Mark Springer
> KPMG Tax Innovation Center
> 202-533-3076
> maspringer@kpmg.com
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 3:42 PM
> To: Bailine, Richard W; Kelliher, William B
> Cc: Smith, Richard H (WNT); Springer, Mark A;
> Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
> Subject: RE: S-corp Product
>
> Richard, we will send you a draft of a pledge for
> your review, thanks, Larry
>
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 12:40 PM
> To: Bailine, Richard W; Kelliher, William B;
> Manth, Larry E
> Cc: Smith, Richard H (WNT); Springer, Mark A

4

Proprietary Material
Confidentiality Requested

KPMG 0046885

3486

> Subject: RE: S-corp Product
>
> Folks--One point I should have made clear. While I
> have no problem with the timing of the shareholders funding of the pledge
> being stretched out, one thing that can NOT happen is that the funding can
> NOT be tied to, or contingent upon, the receipt of distributions (or the
> existence of profits etc) from the S Corp. To do so would simply resurrect
> all the issues we just eliminated. Thanks.
>
> -----Original Message-----
> From: Bailine, Richard W
> Sent: Monday, March 20, 2000 3:34 PM
> To: Kelliher, William B; Manth, Larry E
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> Larry--Bill Kelliher and I had lunch today and
> discussed this business solution idea. We are in agreement that having the
> Put to the S Corp at FMV as of the date of exercise of the Put with a
> shareholder pledge to Exempt-Org as suggested in my March 16th email
> below will enhance the technical aspects of this solution.
>
> I would think that the economics of having the
> shareholder make this pledge would not be materially different (in most
> cases) than having the S Corp do so. One would think the major wealth
> component of most S Corp shareholders is their S Corp stock and,
> ultimately the source of the funds to make this pledge (if funding should
> ever be necessary) would be from the S Corp. I have no problem with the
> shareholders pledge stretching over more than one year to facilitate a
> smooth cash flow. Thus, one will not know for two years (i.e. the expected
> timing of the exercise of the Put) whether funding the pledge will be
> necessary. Assume such funding is necessary, I have no problem with the
> shareholders pledge saying "I will fund this amount over 2 years (or 3, or
> 4 etc years)". This cash flow timing should be worked out between the
> Exempt-Org and the shareholder and be mutually agreeable to them. All I am
> interested in is that this "pledge/guaranty" does not come from the S Corp
> so that in its capacity as an S Corp shareholder, Exempt-Org has no
> downside protection vis-a-vis the stock ownership and no right to a
> preferential distribution. Rights, if any, come from an individual, not
> the corporation.
>
> With these changes, I approve the Sub Chapter C
> aspects of this business solution. Thanks to all for your valuable input
> and helping to achieve the overall desired result!
>
> -----Original Message-----
> From: Kelliher, William B
> Sent: Monday, March 20, 2000 2:53 PM
> To: Manth, Larry E; Bailine, Richard W
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> It's correct (reg. sec. 1.1368-2(d)(1)(i)).
>
> Bill
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Monday, March 20, 2000 9:35 AM
> To: Bailine, Richard W; Kelliher, William B
> Cc: Smith, Richard H (WNT)
> Subject: RE: S-corp Product
>
> Richard, I like your suggestion on the put. If you
> think it strengthens our case, all the better! From the S-corp side,
> since most shareholders think the company is going up in value, they
> should not care. The practical concern is if the company decreases in

5

Proprietary Material
Confidentiality Requested

KPMG 0046886

> value and the shareholder has to pay cash to the tax-exempt -- will the
 > shareholder have enough cash to make the payment if they had not been paid
 > distributions for two years? Perhaps we could extend the pledge for a
 > year longer than the put.

>
 > With respect to the AAA reduction, Bill can confirm
 > this, the example on page 8 is correct.

>
 > Also, with respect to UBIT issues, the tax-exempts
 > we are dealing with are using section 115 to exclude the income from UBIT,
 > so they are not concerned about UBIT.

> Thanks, Larry

>
 >

> -----Original Message-----
 > From: Bailine, Richard W
 > Sent: Thursday, March 16, 2000 4:06 PM
 > To: Manth, Larry E; Kelliher, William B
 > Cc: Smith, Richard H (WNT)
 > Subject: RE: S-corp Product

> Larry/Bill--I think we need to talk in re the
 > following issues.

> Pg 8 of the opinion states that S Corp will reduce
 > AAA by 90% (or some \$7.2 million) even though the amount paid out in
 > redemption of stock is a mere \$1.3 million. Is this correct?

> More importantly, I continue to be concerned that a
 > guaranteed PUT right has the potential effect of giving IRS an argument
 > that no stock has been given to Exempt-Org as Exempt-Org has no downside.
 > More over, as this right to get a guaranteed FMV price runs from the S
 > Corp to Exempt-Org, even if exempt-Org is deemed to be a shareholder why
 > don't we have a second class of stock issue as Exempt-Org certainly has
 > distribution rights that differ from, and are superior to, those of the
 > other shareholder.

> Can we solve all this as follows;

> (i) Assume the S Corp stock has a value of \$1.3
 > million on the date of the gift to Exempt-Org.

> (ii) Give Exempt-Org a right to Put the stock back
 > to S Corp at FMV as of the date the Put is exercised.

> (iii) Have Shareholder make a pledge to Exempt-Org
 > such that he will contribute an amount of money equal to the amount, if
 > any, that any Put proceeds received by Exempt-Org are less than \$1.3
 > million.

> In this way, Exempt-Org is assured of getting the
 > cash BUT the assurance does not come from S Corp. Shouldn't this eliminate
 > the above concerns. Doesn't it also have the effect of helping Exempt-Org;
 > to wit, if the Put is exercised at \$1 million then Shareholder must give
 > \$300,000 to Exempt-Org. Isn't this \$300,000 clearly a charitable gift so
 > that Exempt-Org has no UBIT issues whereas the redemption proceeds may
 > be UBIT.

> Thoughts. Let's talk on Friday.

> -----Original Message-----
 > From: Manth, Larry E
 > Sent: Wednesday, March 15, 2000 12:53 PM
 > To: Bailine, Richard W
 > Cc: Smith, Richard H (WNT); Galbreath, Phillip

3488

> L; Springer, Mark A; Peters, Marsha F; Atkin, Andrew S; Duncan, Douglas P;
> Huber, Robert

Subject: S-corp Product

Rick, please see my comments below.

Thanks, Larry

-----Original Message-----

From: Galbreath, Phillip L

Sent: Monday, March 13, 2000 4:49 PM

To: Manth, Larry E

Cc: Smith, Richard H (WNT); Springer, Mark A;

> Peters, Marsha F

Subject: FW: S-CAEPS

> Below are Rick Bailine's comments relating to the
> Sub C issues in the S-CAEPS whitepaper.

Phillip Galbreath
KPMG Tax Innovation Center
Phone: 202.533.4162
Fax: 202.533.4163
MailTo:pgalbrea@kpmg.com

-----Original Message-----

From: Bailine, Richard W

Sent: Monday, March 13, 2000 7:29 PM

To: Galbreath, Phillip L

Cc: Bloom, Gilbert D; Springer, Mark A; Peters,

> Marsha F

Subject: RE: S-CAEPS

> Phillip--I have read the attached and have the
> following comments related solely to Sub Chapter C.

> 1. This appears to be little more than a old give
> stock to charity and then redeem it play and as pointed out in the
> write-up at footnote 51, the IRS has, for the most part, thrown in the
> towel on these (despite a strong record in court). Having said this please
> read on.

> [Manth, Larry E] Yes, very similar, but during the
> time the tax-exempt owns the stock it will be allocated 90% of the income,
> be paid no distributions, and be redeemed for a small value.

> 2. I think the section 269 discussion is weak. It
> seems clear to me there is an acquisition of control by Exempt-Org as it
> acquires 90% of the number of shares of the S Corp and even if discounted
> at 35% (which would be questionable I think) for lack of voting rights as
> discussed in the write-up at footnote 4, this 90% of the number of shares
> should have >50% of the value of the S Corp (90% times 65%=58.5%). Thus, I
> think the argument is that (i) Exempt-Org receives no tax benefit from the
> acquisition of control, its tax benefits stem from its status under
> section 501 and (ii) the S Corp gets no tax benefit from the acquisition
> of control as its tax benefits stem from its status under section 1361 et
> seq. Thus, the acquisition of control is not material to any tax benefit.
> The write-up does go down this path but spends more time arguing that
> there is no acquisition of control which I think is a mistake. Also, the
> write-up speaks in very conclusive terms when it should be using words
> like "should not apply" as opposed to "...section 269 does not apply...".
> See page 7.

> [Manth, Larry E] See revised technical paper
> attached. Please note that the way the transaction is structured, the

7

Proprietary Material
Confidentiality Requested

KPMG 0046888

> non-voting stock will not be greater than 50% of the value of the S-corp
> (the warrants significantly dilute the value).

>
> 3. My biggest concern is the redemption right given
> to Exempt-Org; why does this right guaranty Exempt-Org will receive cash
> equal to the greater of FMV at time of redemption versus FMV at date of
> gift? This right takes all downside risk away from Exempt-Org and one of
> the hallmarks of ownership is that the owner inherits the "benefits and
> burdens" of ownership. By relieving Exempt-Org of the burden of downside
> risk are we not allowing IRS an alternative argument that Shareholder did
> NOT give S Corp stock to Exempt-Org, rather what was truly given was a
> right to a fixed amount of cash plus a SAR (Stock Appreciation Right).

>
> At page 11, the write-up discusses the potential
> issue that the warrants may be stock and in this light looks at Rev Rul
> 82-150. As for the analysis on this point, I think the write-up is fine
> but this revenue ruling also clearly tells us that if one is to be viewed
> as the owner of equity, one must assume the risks associated with equity
> ownership. Traditionally, one such risk is the risk the equity investment
> will decrease in value. Exempt-Org has no such risk and, therefore,
> arguably may not be viewed as an equity owner..

>
> Moreover, why is this downside protection either
> necessary or desirable? I would think giving Exempt-Org a right to demand
> redemption (i.e. a "put") at FMV as of the date of exercise of the put, is
> more in keeping with the desires of Shareholder and Exempt-Org gets a
> windfall even if it get one cent! It would also seem that put at FMV as of
> date of exercise is truly in keeping with the requirements of Treas Reg
> 1.1361-1(1)(2)(iii). See footnote 20, page 6.

>
> [Manth, Larry E] The reason we guarantee the
> tax-exempt a minimum is that there is a potential burden -- federal taxes.
> It is not a certainty that the tax-exempt is totally exempt from tax on
> holding the stock. Also, very few tax-exempts would ever take this stock
> because of the UBIT concerns. So we are using the floor as an incentive
> for the tax-exempts to take the stock. Hopefully the discussion under
> economic substance regarding beneficial ownership on pages 12 through 19
> will suffice in addressing your concerns on ownership issues.

>
> << File: S_Corp_Strategy.doc >>

>
>
> Let's chat.

>
> -----Original Message-----
> From: Galbreath, Phillip L
> Sent: Monday, March 13, 2000 2:46 PM
> To: Bailine, Richard W
> Subject: FW: S-CAEPS

>
> Attached below is the most recent version of the
> S-CAEPS whitepaper. As I was telling you, this Tax Solution is getting
> some very high level (Stein/Rosenthal) attention. Please review the
> whitepaper as soon as possible and provide your comments to Larry Manth
> directly. Please copy Richard Smith, Mark Springer, Marsha Peters, and me
> on your message to Larry. Thanks for your help.

>
> Phillip Galbreath
> KPMG Tax Innovation Center
> Phone: 202.533.4162
> Fax: 202.533.4163
> MailTo:pgalbrea@kpmg.com

>
>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Sunday, March 12, 2000 10:35 AM
> To: Watson, Mark T; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
> Cc: Atkin, Andrew S; Duncan, Douglas P; Huber,
> Robert
> Subject: RE: S-CAEPS
>
> Mark, thanks for your comments. I will address each
> one separately.
>
> 1) Assignment of Income Issues. We have included
> an additional paragraph under the assignment of income section. But also
> see the economic substance arguments. Bill Kelliher substantially
> enhanced that section and it addresses many issues, including beneficial
> ownership and income allocation.
>
> 2) No charitable or gift tax deduction and
> reallocation of income back to original shareholders. Again, I think the
> economic substance arguments cover these issues. But I am not convinced
> that the Service would be successful in disallowing a charitable
> deduction. After the transaction, the tax-exempt will have cash based on
> the fair market value of the stock. It does nothing but hold the stock.
> The split-dollar transactions have the tax-exempt buy insurance. Also,
> this transaction is quite similar to the charitable FLP. Is this a concern
> for that transaction as well?
>
> 3) Per Larry DeLap's E-mail, we are not discussing
> penalty issues.
>
> 4) Self-Dealing Issues. We have inserted a
> discussion on section 4958, drafted by our EXO-Tax group in D.C. We do,
> however, plan on using only 401's.
>
> Larry
>
>
>
> << File: S_Corp_Strategy.doc >>
>
>
> -----Original Message-----
> From: Watson, Mark T
> Sent: Friday, March 10, 2000 8:24 AM
> To: Manth, Larry E; Smith, Richard H (WNT);
> Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
> Subject: S-CAEPS
>
> OK. I have reviewed the revised S-CAEPS white paper
> and I am still not convinced that the assignment of income issues
> associated with this strategy and the ramifications of Notice 99-36 have
> been adequately addressed and/or considered. The assignment of income
> discussion in the white paper is very brief and contains little case law
> analysis. While the conclusion reached in the white paper on this matter
> may very well be correct, the brief discussion contained in the white
> paper does not give me a tremendous amount of comfort that all of the
> relevant cases and rulings have been considered, particularly wrt whether
> or not the Shareholder is assigning the S corp's earnings to the Exempt
> Organization.
>
> More importantly, the paper's discussion of Notice
> 99-36 seems to miss the point. Yes, we can certainly distinguish the
> S-CAEPS transaction from the transaction that was the subject of Notice

> 99-36, but my point in raising Notice 99-36 is to make sure everyone is
> aware of the potential downside of this transaction. If the Service comes
> after the S-CAEPS transaction the way it attacked the Charitable
> Split-Dollar transaction (and I believe Notice 99-36 and the recent
> section 643(a)(7) regulations indicate it will), clients who enter into
> the S-CAEPS transaction could be faced with a situation where: (1) they
> don't get an income OR gift tax charitable contribution deduction for the
> contribution of the S-Corp stock to charity (and, thus, they may incur a
> substantial gift tax liability); and (2) they are required to recognized
> all or most of the S corp's earnings. Further, as stated in Notice 99-36,
> the Service may attempt to impose a variety of penalties on the
> participants in this transaction (including KPMG) including the penalty
> under section 6701 for aiding and abetting the understatement of tax
> liability. Finally, the white paper contains no discussion as to why the
> Service cannot claim the S-CAEPS transaction involves private inurement,
> an impermissible private benefit, or self dealing, all issues raised in
> Notice 99-36. Perhaps if the "Exempt-Org" is a section 401(a) entity
> rather than a section 501(c)(3) entity these issues go away. If so, the
> white paper should so indicate.

>
> Mark T. Watson
> Partner
> KPMG - Washington National Tax
> 202-533-3092 (phone)
> 202-533-8451 (fax)
>

Message0003	
Subject:	FW: S-Corporation Charitable Contribution Strategy (SC2)
From:	Messing, Steven G
Date:	4/25/2000 7:34:02 AM
To:	Silver, Lawrence G
Message Body	
Please do not forward this to anyone.	
<p>Steve Steven G. Messing, Partner KPMG LLP (305) 913-2638 (305) 913-2692 (fax) E-mail Smessing@KPMG.com</p> <p>-----Original Message----- From: DeLap, Larry Sent: Tuesday, April 11, 2000 7:52 PM Posted To: Tax Professional Practice Partners Conversation: S-Corporation Charitable Contribution Strategy (SC2) Subject: S-Corporation Charitable Contribution Strategy (SC2)</p>	
<p>Attached are a white paper and approved engagement letter for the S-Corporation Charitable Contribution Strategy (SC2) and an upcoming Tax Solution Alert.</p> <p>The strategy involves the transfer of a substantial portion of S corporation stock to a section 401(a) governmental pension plan, with the intention that such stock be redeemed from the pension plan after about two years. The intent that is that most of the earnings of the S corporation would be allocated to the pension plan during the period it owns the S corporation stock, but relatively little of the earnings would be distributed during that period.</p> <p>This is a relatively high risk strategy. You will note that the heading to the preapproved engagement letter states that limitation of liability and indemnification provisions are not to be waived. On a showing of good cause, appropriate modifications to the standard limitation of liability and indemnification provisions can be made. You will also note that the engagement letter includes the following statement:</p> <p>You acknowledge receipt of a memorandum discussing certain risks associated with the strategy and represent that you have read and understand the matters discussed in that memorandum.</p>	

Proprietary Material
Confidentiality Requested

KPMG 0052581

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 122

It is essential that such risk discussion memorandum (attached) be provided to each client contemplating entering into an SC2 engagement.

It is not contemplated that we would be engaged by the section 401(a) governmental pension plan that is the recipient of the S corporation stock. However, if we were engaged by the 401(a), the team serving the 401(a) should be different than the team serving the S corporation and its shareholder, and we should get a signed letter from each of the parties acknowledging the dual representation and waiving any claim of conflict of interest.

Sample legal documents are planned to be used by the deployment team. As indicated on the attached, such sample documents are to be provided only to the client's legal counsel for legal counsel's consideration in drafting the applicable documents. The sample documents are not to be provided directly to the client.

Larry

Attachment

Corporate_forms2.doc

Attachment

SC2_Whitepaper.doc

Attachment

SC2_Engage.doc

Attachment

SC2_TSA.DOC

Attachment

SC2_Risk_Analysis.doc

Outlook Header Information

Conversation Topic: S-Corporation Charitable Contribution Strategy (SC2)

Subject: FW: S-Corporation Charitable Contribution Strategy (SC2)

From: Messing, Steven G.

Sender Name: Messing, Steven G.

To: Silver, Lawrence G.

Received By: Silver, Lawrence G.

Delivery Time: 4/25/2000 7:34:02 AM

Creation Time: 4/25/2000 7:32:45 AM

Modification Time: 10/31/2000 11:26:52 AM

Submit Time: 4/25/2000 7:33:58 AM

Importance: 4/1

Priority: 4/0

3494

Sensitivity: 4/0
Flags: 4/17
Size: 4/330554

Proprietary Material
Confidentiality Requested

KPMG 0052583

S-Corporation Charitable Contribution Strategy – Variation #1

OVERVIEW. This variation allows the donor to specify the ultimate recipient of the proceeds of the redemption. A structure similar to SC² is used in which the S-corporation is recapitalized (non-voting stock and warrants) whereby the non-voting stock is gifted to a 501(c)(3), in which the 501(c)(3) will accept the gift of the S-corp stock, pay tax on, at most, 50% of the income it is allocated, redeem the stock after a specified period of time, and disburse the redemption proceeds to the shareholder specified charity. The shareholder will fund the tax to be paid by the 501(c)(3) and has a number of tax efficient alternatives to do so.

BENEFITS. The benefits of this variation is approximately 50% - 60% (could be as much as 100% in some cases) of the benefits achieved by the SC² strategy (see attached analysis). A summary of the benefits are as follows:

- 1) Charitable contribution deduction on gift of S-corp stock,
- 2) .90% of the income is allocated away from the shareholder(s) to a 501(c)(3),
- 3) The 501(c)(3) that owns the stock is allowed to exclude 50% of such income from its UBIT calculation,
- 4) The tax that is paid by the 501(c)(3) can be funded by the shareholder (or S-corporation) in a number of ways. One such method is for the shareholder to establish a trust that would allow for the amounts paid to the 501(c)(3) to be deducted by the shareholder. Another method is for the shareholder to gift appreciated securities to the 501(c)(3), thereby avoiding tax on the gain as well as receiving a deduction for the FMV.

ADVANTAGES OVER SC². There are at least three advantages in utilizing this alternative structure:

- 1) No hostage situation. Since the shareholder will be indirectly funding the tax liability, the 501(c)(3) will not want to hold the stock if it has to pay tax that is not effectively reimbursed by the taxpayer.
- 2) Choice of Charity. The 501(c)(3) that accepts the stock is an organization that is established to make charitable donations to other charitable entities. Although the 501(c)(3) may not be a desired charity of the taxpayer, the ultimate cash that is paid to redeem the stock can be earmarked for a specific charity of the taxpayer's choice.
- 3) Beneficial Ownership. Since the 501(c)(3) that owns the S-corporation stock will be paying tax on such ownership, there seems to be a stronger argument with respect to beneficial ownership (probably our weakest link in the chain on SC²).

COSTS. Since we are in the beta test mode on this variation, our pricing is flexible. However, we need to keep in mind that the time to implement will probably be at least 150% - 200% of SC²'s time. In the benefit analysis provided above, we have assumed a 7.5% fee (7.5% times first year's income). Additional costs, (typically not part of SC²) include additional attorney fees for establishing a trust (if being used to fund 501(c)(3)'s tax liability), tax preparation work for the trust, and potential trust management fees on the value of the non-voting stock held by the 501(c)(3) (these fees could range from 1.5% - 3% of the value of the non-voting stock).

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 125

KPMG 0047895

ATTACHMENT – BENEFIT ANALYSIS – 2 AND 3 YEAR HOLDS



benefit analysis 2
year.xls



benefit analysis 3
year.xls

To: Larry Manth, Andrew Atkins, Douglas Duncan, Robert Huber/ KPMG-LA

From: Bill Kelliher/ KPMG-WNT

Date: March 2, 2000

Re: Comments on S-CAEPS "White Paper"

These comments relate to the S-CAEPS White Paper dated February 24, 2000, and only address the S corporation-related issues.

- Fn. 22, on pg. 7, cites Rev. Rul. 67-269. That ruling was declared obsolete by Rev. Rul. 95-71, 1995-2 CB 323. It was superceded by reg. sec. 1.1361-1(l)(4)(iii), the provision in the one-class-of-stock regulations addressing options, warrants and similar instruments. The current rules do not take the same position as Rev. Rul. 67-269 that options and warrants have none of the attributes of immediate stock ownership. Instead, they provide that an option or warrant issued by an S corporation will be treated as an outstanding second class of stock of the corporation if, based on all the facts and circumstances, the option or warrant is substantially certain to be exercised and has a strike price substantially below the fair market value of the underlying stock on any of three specified dates: the date the option or warrant is issued, the date it is transferred by a person who is an eligible shareholder of an S corporation to a person who is not, or the date the option or warrant is materially modified. Accordingly, the sentence on pg. 7 to which the footnote relates should be revised to state that the warrants should not count as outstanding stock for purposes of determining the allocation of the taxable income of the S Corp *provided that their strike price can be shown to be not substantially below the fair market value of the stock on the date the options are issued or that they may be materially modified.*
- At the top of pg. 11, an example from a journal article is cited to illustrate the exception in reg. sec. 1.1361-1(l)(4)(iii)(C) that the failure of an option or warrant to satisfy the "at least 90% of fair market value" safe-harbor will not necessarily result in the option or warrant being treated as a second class of stock. The example is of a warrant with an exercise price equal to 50% of fair market value arguably not being treated as a second class of stock if the time to maturity is long and the value of the stock is volatile. That result is mere speculation by the author of the article. There is no authoritative evidence that the IRS would not treat the warrants as outstanding equity under such facts. Besides, are we likely to be marketing this strategy to many S corporations with volatile stock valuations? In addition, if by his reference to "the time to maturity is long", the author means that the exercise period does not expire for a long time, I disagree with the inference that the IRS would view an immediately exercisable warrant with a strike price significantly below the date-of-issue fair market value as not being "in the money" simply because it does not lapse for a long time. Alternatively, if he means that a significant valuation discount may be appropriate because it can not be exercised for a long time, that does not fit a fact

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 125

KPMG 0016853

pattern in which the warrants are immediately exercisable. Overall, I think that example is more misleading than helpful.

- I believe that the third paragraph on pg. 12 misinterprets the Tax Court's decision in *Hume v. Commissioner* (not *Humer*) and should be deleted. In the context of the S-CAEPS strategy, we would be concerned that the IRS might raise the issue of *beneficial* ownership, not *constructive* ownership. In *Hume*, the Tax Court did, indeed, conclude that constructive ownership of stock of an S corporation does not make the constructive owner a shareholder of the corporation for purposes of former sec. 1371(a)(2) [current sec. 1361(b)(1)(B)]. However, the issue in that case related to the treatment of a party that was the constructive owner of the stock under the sec. 318 stock ownership attribution rules. The taxpayer, who was the principal shareholder of an S corporation, argued that he should not have to report his ratable share of the corporation's taxable income because its S election allegedly terminated. The taxpayer's rationale for claiming that a termination had occurred was that he owned another corporation and, under sec. 318(a)(3)(C), any stock of the S corporation that he owned would be treated as being owned by the other corporation. Since a corporation is not an eligible shareholder of an S corporation, the taxpayer argued that the S corporation's S election should be treated as having terminated. The Tax Court handily dispensed with that argument by holding that, for purposes of subchapter S, *constructive* ownership is disregarded.
- Our real concern is *beneficial* ownership. It arises in the context of Potential IRS Argument 4 (*i.e.*, that there is no economic substance to the proposed transaction). I would expect the IRS to argue that, viewed in its totality, the transaction lacks economic substance because it purports to shift 90% of the S corporation's income to the exempt organization, while using the warrants to cap the economic value of that 90% interest at 11.25% of the economic value of the corporation (ignoring any discount for lack of control and lack of marketability). The issue of beneficial ownership could arise if the IRS were to contend that, although legal ownership of 90% of the stock was transferred to the exempt entity, only an 11.25% beneficial ownership interest was transferred. In that event, the IRS could then argue that the beneficial ownership interest governs and, therefore, only 11.25% of the S corporation's income is allocable to the exempt entity.

In Rev. Rul. 70-615, 1970-2 CB 169, the IRS held that, for purposes of determining who is a shareholder under the provisions of subchapter S, beneficial ownership of the stock, rather than technical legal title is controlling. *Hume v. Commissioner*, cited above, in addition to addressing the constructive ownership issue, also reaches the same conclusion as Rev. Rul. 70-615 with respect to beneficial v. legal ownership. So do the following cases, all relating to stock ownership of S corporations:

Pahl v. Commissioner, 98-2 USTC 50,602 (9th Cir. 1998), aff'g. 71 TCM 2744 (1996);

Wilson v. Commissioner, 77-2 USTC 9684 (5th Cir. 1977), aff'g. 34 TCM 463 (1975);

KPMG 0016854

Pacific Coast Music Jobbers, Inc. v. Commissioner, 72-1 USTC 9317 (5th Cir. 1972);
Lafayette Distributors, Inc. v. U.S., 75-2 USTC 9609 (DC, La. 1972);
Hoffman v. Commissioner, 68-1 USTC 9284 (5th Cir. 1968), aff'g. 47 TC 218 (1966);
Hang v. Commissioner, 95 TC 74 (1990);
T.J. Henry Assocs., Inc v. Commissioner, 80 TC 886 (1983);
Danenberg v. Commissioner, 73 TC 370 (1979);
Ragghianti v. Commissioner, 71 TC 346 (1978);
Hook v. Commissioner, 58 TC 267 (1972);
Kean v. Commissioner, 51 TC 337 (1968);
Willie v. Commissioner, 61 TCM 2475 (1991);
Kirkpatrick v. Commissioner, 36 TCM 1122 (1977).

A recent example of the IRS' position on whether a transfer of the legal ownership of stock should be respected as a transfer of stock ownership for federal income tax purposes can be found in IRS Field Service Advice 200006017. Although the facts of the FSA involve stock of a C corporation, rather than an S corporation, the issues and analysis are the same in both cases. The FSA states:

"In order to be respected for federal income tax purposes, the transfer of stock from Mr. A to Mrs. A must have economic substance. See, e.g., *Specia/Madrigrano v. Commissioner*, 630 F.2d 554, [80-2 USTC 9692] (7th Cir. 1980) (taxpayers' purported transfer of stock to their children lacked sufficient economic substance and, therefore, the taxpayers were deemed to be the beneficial owners for tax purposes). Economic substance frequently comes into question when there is a transfer of stock between family members. In these cases, 'special scrutiny is necessary, lest what is in reality but one economic unit be increased to two or more by devices which, though valid under state law, are not conclusive' for federal income tax purposes. *Helvering v. Clifford*, 309 U.S. 331, 335 (1940). In order for the instant transfer to be respected for tax purposes, Mrs. A must be determined to be the true beneficial owner after the transfer, not just the owner in form alone. See *Anderson v. Commissioner*, 164 F.2d 870 (7th Cir. 1947), cert. denied, 334 U.S. 819 (1948).

As stated, in determining the true ownership of corporate stock, beneficial ownership, as opposed to holding mere legal title, is decisive. *Bierne v. Commissioner*, 61 TC 268, 277 (1973). See also, Mertens, Law of Federal Income Taxation @ 38:09. Ownership of property is determined by command over property or enjoyment of its economic benefits. *Anderson, supra*, at 873. The issue of the appropriate standards to be applied in determining true beneficial ownership is a question of law. *Wilson v. Commissioner*, 560 F.2d 687 (5th Cir. 1977). However, the question of whether an

KPMG 0016855

individual meets these standards and qualifies as a true beneficial owner is a question of fact. *Id.*

In determining true beneficial ownership, courts have employed a four-factor analysis. See *Specia/Madrigrano, supra*; *Duarte v. Commissioner*, 44 TC 193 (1965); *Bierne v. Commissioner*, 61 TC 268 (1973); *Kirkpatrick v. Commissioner*, TC Memo 1977-281. ...

The four factors that have been used by the courts to determine the true beneficial ownership of corporate stock after a questionable transfer are discussed below:

1. Whether the transferees within the family are able to effectively exercise ownership rights of their shares. ... [Examples of the existence or lack of effective control include: whether transferees could have *effective* ownership rights (e.g., were they minors without independent legal representatives?); could the transferee fully participate in corporate decision-making by virtue of stock ownership? (e.g., could the transferee exercise stock voting rights?)]
2. Whether the transferor continued to exercise complete dominion and control over the transferred stock. ...
3. Whether the transferor continued to enjoy economic benefits of ownership after conveyance of the stock. ... [For example, payment of minimal dividends or no dividends to the transferee, while the corporation earned substantial profits indicates retention of economic benefits by the transferor.]
4. Whether the transferor dealt at arm's length with the corporation involved. ... [For example, if the transferor obtained loans from the corporation at less than arm's-length terms or otherwise used the corporation as a 'personal pocketbook'.]

Variations of the above four factors have also been listed in several private letter rulings. In PLR 9022029, the IRS considered the following factors:

1. Whether the transferee has full, independently exercisable voting rights in the stock.
2. Whether the transferee has the right to receive all of the dividends payable on the stock.
3. Whether the transferee is entitled to sell, dispose of. Or encumber the stock at its sole discretion, without approval of the transferor or the other shareholders.
4. Whether the transferee has the right to receive the proceeds of any liquidating distribution.

PLR 8536017 looked to:

1. Whether the transferee had the right to receive distributions.
2. Whether the transferee had the right to participate in management.
3. Whether the transferee would economically participate in future business activities of the corporation.
4. Whether the transferee had the right to share in assets in the event of the corporation's dissolution.

It might be argued that the FSA and the two PLRs are distinguishable from the S-CAEPS fact pattern because the former involve intra-family transfers of stock, while the latter involves a transfer of stock to an unrelated and uncontrolled exempt organization. However, although the fact patterns differ, nothing suggests that the issue and analysis apply only to intra-family stock transfers. Instead, the case law supports the position that they are applicable to any situation in which the facts indicate a purported transfer of ownership of corporate stock may lack economic substance. Consequently, I believe that would not be a productive defense.

The IRS may contend that in the S-CAEPS strategy, (i) the transitory nature of the shift of taxable income from a taxable shareholder to an exempt organization, (ii) the intent not to pay any dividends during the period of time the exempt organization owns the stock, (iii) the use of non-voting stock, (iv) the use of the warrants to cap the economic value of exempt organization's stock and (v) the ratio of the transferor's tax benefits to economic cost create a *prima facie* case that the economic substance of the transaction is that the exempt organization is the beneficial owner of only 11.25% of the stock of the S corporation and the transferor remained the beneficial owner of the remaining 89.75%. If the IRS were to prevail in such a contention, the shift in taxable income from the transferor to the exempt organization would be only 11.25%.

▪ Our response to the possible IRS challenge:

To overcome such an IRS position, I believe it is necessary to show that (i) the transition has economic substance and (ii) that the transferor satisfies the tests proving the transfer of beneficial ownership of the full 90% of the stock, based on the facts and circumstances of the specific S-CAEPS transaction.

The transaction has economic substance. There are several responses to the IRS' possible contention that the transfer of 90% of the stock of the S corporation to the exempt organization lacks economic substance because the effect of the warrants is to ensure that no more than 11.25% of the economic value of the equity of the corporation is shifted to the exempt organization.

1. It is common for closely-held corporations that issue stock to key employees who are not the "founders" of the corporation to require that those "non-founding" shareholders enter into buy-sell or redemption agreements that does not apply to the stock of the "founding" shareholders. For example, such agreements commonly provide that if a "non-founding" shareholder leaves the employ of the corporation or otherwise wishes to dispose of his/ her stock, the corporation will redeem

it at a fixed price, such as book value. As a practical matter, book value may be substantially less than fair market value. In such situations, if the corporation is an S corporation, the per-share flow-through of S corporation income, gain, loss, deductions and credits to the "non-founder" shareholders is the same as it is to the "founding" shareholders who are not subject to the buy-sell or redemption agreement.

In such situations, there is no authority to support treating the "non-founding" shareholders as beneficially owning less than their actual amount of stock simply because their stock could be redeemed at a lower price per share than that of the "founding shareholders. Nor has the IRS ever argued that such treatment would be appropriate. Reg. sec. 1.1361-1(l)(2)(v), Example 9, contains exactly such a fact pattern. The example concludes that the terms of the redemption agreement are disregarded in determining whether the S corporation has a second class of stock unless a principal purpose of the redemption agreement is to circumvent the sec. 1361(b)(1)(D) one-class-of-stock requirement. The "principal purpose" issue has already been addressed at pgs. 6-7 and we have concluded that no principal purpose of avoidance exists.

The redemption agreement in the S-CAEPS strategy is analogous to the "non-founder" buy-sell or redemption agreement approved in reg. sec. 1.1361-1(l)(2)(v), Example 9. As a result, the fact that the former applies only to the exempt organization and results in capping the economic value of the exempt organization's stock should not cause the IRS to characterize it as lacking in economic substance.

2. The transfer of 90% of the S corporation's stock to the exempt organization not only means that 90% of income and gains are allocable to the exempt organization, it also means that, in the event the S corporation incurs losses, the tax benefit of 90% of those losses would be allocated to the exempt organization. Accordingly, the 90% allocation has the potential for tax detriment, as well as tax benefit, to the transferor.
3. Any income or gains of the S corporation allocable to the exempt organization while it is a shareholder will increase the tax basis of the S corporation stock. The transferor will obtain no stock basis increase for the income or gain allocable to the exempt organization. To the extent that dividend distributions to the exempt organization during the period of time that it is a shareholder of the S corporation are less the exempt organization's allocable share of income or gain, those undistributed earnings would subsequently be available for distribution to the transferor. However, the transferor will have no stock basis to enable the distribution(s) to be received as a tax-free recovery of basis under sec. 1368(b)(1). If the earnings that were allocated to the exempt organization are subsequently distributed to the transferor, they will be taxable to him

or her under sec. 1368(b)(2) or (c)(2). Accordingly, when all of the tax consequences of the overall transaction are taken into consideration, we believe that there is no excessive tax benefit to the transferor when compared to the economic costs to the transferor.

4. The Small Business Job Protection Act of 1996, by adding sec. 1361(c)(6) and amending sec. 1361(b)(1)(B), specifically authorized and approved the transfer of stock of an S corporation to an exempt charitable organization in taxable years beginning after December 31, 1996. An automatic consequence of such a transfer is a shift of flow-through income, gain or loss allocable to the transferred shares from the transferor to the exempt organization. Typically, when stock of a closely-held corporation is donated to a charitable organization, the expectation of the parties is that, although the charity may hold the stock for a period of time, it will ultimately be tendered for redemption. This transaction does nothing more than is contemplated by the statute.

The transferor has transferred beneficial, as well as legal, ownership of 90% of the stock to the exempt organization. Based on an analysis of the factors cited by the courts and the IRS, we believe that the transferor has transferred beneficial ownership of the full 90% of the stock of the S corporation and that the transfer should be respected for federal income tax purposes. An analysis of those factors in the context of this transaction follows.

1. Whether the exempt organization is able to effectively exercise ownership rights of its shares. Under the facts, the exempt organization is an independent party not under the control of the transferor and is able to fully exercise all of its rights as a shareholder.
2. Whether the transferor continued to exercise complete dominion and control over the transferred stock. Under the facts, the exempt organization has not waived any of its rights as shareholder. It is entitled to notice of shareholder meetings and has the right to attend those meetings. It has the same rights as other shareholders to inspect corporate books and records. There is no retention by the transferor of any dominion or control over the transferred stock.
3. Whether the transferor continued to enjoy economic benefits of ownership after conveyance of the stock. This is a potential weak point if no dividends are paid during the period of time that the exempt organization owns the stock. As noted above, the absence of any dividend payments while the corporation enjoyed substantial earnings has been viewed as evidence of the transferor's retention of economic benefits. Accordingly, it may be appropriate to advise that more than a *de minimis* amount of dividends should be paid during the period of time that the exempt

organization owns the stock and that the dividend payment reflect the 90%-10% ownership ratio.

4. Whether the transferor dealt at arm's-length with the corporation involved. This will depend on the facts and circumstances of the specific S corporation and its shareholder. Any post-transfer transactions between the transferor and the corporation that could confer an economic benefit on the transferor should be at arm's length. For example, any loans from the S corporation to the transferor should be at arm's-length terms, be properly documented and appropriately secured. Use of corporate assets (e.g., vacation property, aircraft, vehicles, etc.) by the transferor at less than arm's-length terms should be avoided.
5. Whether the exempt organization has full, independently exercisable voting rights in the stock. Since the stock to be transferred to the exempt organization will be non-voting, this would be a negative factor.
6. Whether the exempt organization will have the right to receive all of the dividends payable on the stock. The exempt organization has exactly the same rights to dividend, to the extent that any are declared, that the transferor has. [However, see the comment in 3, above.]
7. Whether the exempt organization is entitled to sell, dispose of, or encumber such stock at their sole discretion without the approval of the transferor. Except for the restriction against any transfer of its stock that would cause the corporation's S election to be terminated, the exempt organization's stock is freely alienable without the approval of any other party.
8. Whether the exempt organization has the right to receive the proceeds of any liquidating distribution. In the event of the liquidation of the S corporation while the exempt organization is a shareholder, its stock has the same per-share right to liquidations proceeds as the stock of the transferor.
9. Whether the exempt organization has the right to participate in management. Under applicable state business corporation statutes, shareholders generally have no right to participate directly in the management of the activities of the S corporation solely by virtue of their stock ownership. Absent any contrary provisions in the S corporation's by-laws, a shareholder's only direct right with respect to management is that owners of shares of voting stock are permitted to vote for members of the S corporation's board of directors, who generally have the authority to appoint management. Under the facts of the S-CAEPS strategy, the exempt organization will hold only non-voting stock. However, as a shareholder, the exempt organization will have full rights to attend and

participate (except for voting) in shareholder meetings and will have access to the S corporation's books and records.

10. Whether the exempt organization's stock will economically participate in future business activities of the corporation. There is no arrangement in effect, nor is any contemplated, that would have the effect of preventing the shares of stock owned by the exempt organization from participating in any future business activities of the S corporation.
- On pg. 16, I believe that the final paragraph of Potential IRS Argument 4 can be deleted. In view of the point addressed above, that the transaction has several significant potential tax detriments to the transferor, it should be unnecessary to refer to any 10 to 1 ratio of tax benefits to economic costs. Consequently, there is no reason to mention "feeling comfortable" with such a ratio.

Sequential

From: Watson, Mark T [mwatson@KPMG.com]
 Sent: Monday, March 13, 2000 6:33 PM
 To: Manth, Larry E; Smith, Richard H (Vice Chair-Tax); Rosenthal, Richard P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
 Cc: Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
 Subject: RE: S-CAEPS

Larry, after spending the afternoon reviewing assignment of income cases, I generally feel more comfortable with the conclusion set forth in the white paper. Nonetheless, in the context of a professional services corporation (e.g., an S corporation in which doctors are the shareholders), I still think assignment of income is a potential problem and merits further consideration.

Wrt the charitable contribution deduction, if the deduction claimed by the Shareholder is similar to the redemption price paid to the Exempt-Org, which, based on footnote 4 of the white paper, I am assuming is the plan, then perhaps the argument set forth in the white paper is sufficient. However, we, and certainly clients who enter into this transaction, should understand that in order for a transfer to qualify for a charitable contribution deduction, the contribution must be a voluntary transfer of money or other property without the present or anticipated receipt by the donor of more than a purely incidental economic consideration or other benefit in return. See e.g., U.S. v. American Bar Endowment, 477 U.S. 105 (1986) and Comr. v. Duberstein, 363 U.S. 278 (1960). The way the strategy is structured, I don't think it would be difficult for the Service to argue that the contribution of the stock by the Shareholder to the Exempt-Org did not involve a transfer of property without the anticipated receipt by the Shareholder of more than a purely incidental benefit.

Finally, as to your question regarding the charitable FLP, yes, the charitable contribution deduction issue is a concern for that transaction as well. That is why we did not hard-wire the redemption price for the interest given to charity. Rather, the price that will be paid to charity for its partnership interest will be based on an appraisal of such interest at the time of the redemption, and we are not using any put formulas or warrants to depress the price of charity's interest.

> -----Original Message-----

> From: Manth, Larry E
 > Sent: Sunday, March 12, 2000 10:35 AM
 > To: Watson, Mark T; Smith, Richard H (WNT); Rosenthal, Richard P;
 > Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
 > Cc: Atkin, Andrew S; Duncan, Douglas P; Huber, Robert
 > Subject: RE: S-CAEPS

> Mark, thanks for your comments. I will address each one separately.

> 1) Assignment of Income Issues. We have included an additional paragraph under the assignment of income section. But also see the economic substance arguments. Bill Kelliher substantially enhanced that section and it addresses many issues, including beneficial ownership and income allocation.

> 2) No charitable or gift tax deduction and reallocation of income back to original shareholders. Again, I think the economic substance arguments cover these issues. But I am not convinced that the Service would be successful in disallowing a charitable deduction. After the transaction, the tax-exempt will have cash based on the fair market value of the stock. It does nothing but hold the stock. The split-dollar transactions have the tax-exempt buy insurance. Also, this transaction is quite similar to the charitable FLP. Is this a concern for that transaction as well?

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 126

KPMG 0013790

> 3) Per Larry DeLap's E-mail, we are not discussing penalty issues.
 >
 > 4) Self-Dealing Issues. We have inserted a discussion on section 4958,
 > drafted by our EXO-Tax group in D.C. We do, however, plan on using only
 > 401's.
 >
 > Larry
 >
 >
 >
 > << File: S_Corp_Strategy.doc >>
 >
 >
 > -----Original Message-----
 > From: Watson, Mark T
 > Sent: Friday, March 10, 2000 8:24 AM
 > To: Manth, Larry E; Smith, Richard H (WNT); Rosenthal, Richard
 > P; Springer, Mark A; DeLap, Larry; Galbreath, Phillip L
 > Subject: S-CAEPS
 >
 > OK. I have reviewed the revised S-CAEPS white paper and I am still
 > not convinced that the assignment of income issues associated with this
 > strategy and the ramifications of Notice 99-36 have been adequately
 > addressed and/or considered. The assignment of income discussion in the
 > white paper is very brief and contains little case law analysis. While
 > the conclusion reached in the white paper on this matter may very well be
 > correct, the brief discussion contained in the white paper does not give
 > me a tremendous amount of comfort that all of the relevant cases and
 > rulings have been considered, particularly wrt whether or not the
 > Shareholder is assigning the S corp's earnings to the Exempt Organization.
 >
 >
 > More importantly, the paper's discussion of Notice 99-36 seems to
 > miss the point. Yes, we can certainly distinguish the S-CAEPS transaction
 > from the transaction that was the subject of Notice 99-36, but my point in
 > raising Notice 99-36 is to make sure everyone is aware of the potential
 > downside of this transaction. If the Service comes after the S-CAEPS
 > transaction the way it attacked the Charitable Split-Dollar transaction
 > (and I believe Notice 99-36 and the recent section 643(a)(7) regulations
 > indicate it will), clients who enter into the S-CAEPS transaction could be
 > faced with a situation where: (1) they don't get an income OR gift tax
 > charitable contribution deduction for the contribution of the S-Corp stock
 > to charity (and, thus, they may incur a substantial gift tax liability);
 > and (2) they are required to recognize all or most of the S corp's
 > earnings. Further, as stated in Notice 99-36, the Service may attempt to
 > impose a variety of penalties on the participants in this transaction
 > (including KPMG) including the penalty under section 6701 for aiding and
 > abetting the understatement of tax liability. Finally, the white paper
 > contains no discussion as to why the Service cannot claim the S-CAEPS
 > transaction involves private inurement, an impermissible private benefit,
 > or self dealing, all issues raised in Notice 99-36. Perhaps if the
 > "Exempt-Org" is a section 401(a) entity rather than a section 501(c)(3)---
 > entity these issues go away. If so, the white paper should so indicate.
 >
 >
 > Mark T. Watson
 > Partner
 > KPMG - Washington National Tax
 > 202-533-3092 (phone)
 > 202-533-8451 (fax)
 >

Sequential

From: Rosenthal, Richard P [rosenthal@KPMG.com]
Sent: Saturday, March 11, 2000 1:48 PM
To: Manth, Larry E
Cc: Duncan, Douglas P; DeLap, Larry
Subject: RE: Pre- Marketing

Larry, I'm all for pre-marketing. Hopefully, this will save a couple of weeks internally. However, it needs to be absolutely clear that no one should be going out to market this product directly to any clients or non clients until it is approved. I know you understand that but you need to emphasize this point to the area product champions so there is no misunderstanding! I've copied Larry so if there is anything else he is concerned about, we can address it.

Thanks!

Rick

> -----Original Message-----

> From: Manth, Larry E
 > Sent: Friday, March 10, 2000 9:09 AM
 > To: Rosenthal, Richard P
 > Cc: Duncan, Douglas P
 > Subject: Pre- Marketing

>
 > Rick, we would like to begin calling offices around the country so that we
 > can complete our target list. Specifically, we have the list provided by
 > Montvale of S-corp clients of the firm and need additional information in
 > certain areas such as partners and managers on the account, certain income
 > information, etc. We are not going to discuss the product, but would like
 > to have this information ready so that we can begin marketing as soon as
 > the product is approved. We have some available time now to start this
 > process. Is this something that we need permission from DC or DeLap
 > before we begin? Thanks, Larry

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
 Sent: Friday, March 03, 2000 1:43 PM
 To: Manth, Larry E
 Subject: RE: S corp Strategy

Larry -

It is my view that, where a valuation is an integral element of an aggressive tax strategy promoted by us, the client should have it performed by an independent valuation firm.

Larry

> -----Original Message-----
 > From: Manth, Larry E
 > Sent: Friday, March 03, 2000 10:34 AM
 > To: DeLap, Larry
 > Subject: S corp Strategy
 >
 > Larry, in regards to the valuation work necessary to implement the
 > strategy, is there any way that we can use our own valuation group (maybe
 > have a different office? separate engagement letter and separate fee?).
 > It would make the implementation much more smoother for us.
 >
 > Thanks, Larry
 >
 >

3510

Unknown

From: Delap, Larry [ldelap@KPMG.COM]
Sent: Tuesday, October 31, 2000 4:28 PM
To: Manth, Larry E
Subject: FW: SC2

Redacted by
Permanent Subcommittee
on Investigations

Larry -

Rick Rosenthal's remarks on yesterday's conference call suggest that the concept of involving section 501(c)(3) organizations in SC2 may be farther along than indicated below. Please be sure to get DPP-Tax (as well as [REDACTED]) clearance before involving section 501(c)(3) organizations.

Larry

> -----Original Message-----
> From: Speizman, Richard A
> Sent: Wednesday, October 25, 2000 3:51 PM
> To: Manth, Larry E
> Cc: Springer, Mark A; Delap, Larry
> Subject: RE: SC2
>
> Larry,
>
> I am in Orlando - maybe we can hook up.
>
> Very briefly - certain "governmental entities" - organizations that
> would either (1) not be subject to federal income taxes because they
> are an "integral part" of a state or political subdivision thereof, or
> (2) organizations whose income is excludible under section 115, apply
> for and receive recognition of section 501(c)(3) status. This is not
> for income tax purposes (they are already not subject to tax), but to
> make their employees eligible to participate in section 403(b)
> tax-sheltered annuities, to make it clearer to potential donors that
> they qualify for deductible contributions, and for other reasons.
> Examples include certain state universities, county and municipal
> hospitals, and other types of organizations. These might well be good
> targets for your solution.
>
> Once an organization is recognized under section 501(c)(3), it is
> subject to all of the rules applicable to such an organization,
> regardless of any other basis on which it might not pay federal income
> tax. Thus, we would be concerned about the tax exemption,
> intermediate sanctions and other issues raised in our memo.
>
> I would also point out that contributions to or for the use of any
> organization described in section 170(c)(1) are eligible for
> charitable contribution deductions. Thus, gifts to an "integral part"
> organization may qualify, even if it does not have exemption under
> section 501(c)(3). Certain state universities that never applied for
> recognition under section 501(c)(3), for example, might fall into this
> category.
>
> If we don't hook up in Orlando, I will be in the office next week.
>
> Rick Speizman
> Exempt Organizations Tax Practice
> Washington National Tax
>
> Phone: (202) 533-3084
> Fax: (202) 533-8554
> E-mail: rspeizma@kpmg.com

Proprietary Material
Confidentiality Requested

KPMG 0015011

1

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 126

3511



>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, October 25, 2000 5:41 PM
> To: Speizman, Richard A
> Cc: Springer, Mark A; DeLap, Larry
> Subject: RE: SC2
>
> Richard, perhaps we can discuss in person if you have time while in
> Orlando, but in case we don't talk I'll try and respond as best as I
> can to your e-mail below. I have been getting a lot of pushback in
> the different areas with respect to finding other charities that
> clients could gift to in SC2. We briefly went down the UBIT NOL road
> again to see if in fact those entities exist with respect to
> sufficient NOL carryovers. I think we sent out some e-mails and did
> some searching on the internet and did not find any entities with
> sufficient NOLs (neither did we discuss anything with any entity). A
> couple of weeks ago we became aware of a couple of PLRs recently
> issued that allowed for a 501(c)(3) to have 115 status -- which is the
> section that the public pension plans claim exclude them from UBIT. I
> called Gary Oyach in WNT to discuss the ruling and he told me that he
> was aware of those entities because they are typically entities that
> are part of a city or state and get 501(c)(3) status to qualify for
> 403(b) (I think that is the section) plans. I found this very
> interesting and asked him if he was aware of any by name and he told
> me about the [REDACTED]. He said that he thought we just lost the work to
> PWC, and said that he recalled that they had the 115 immunity. I
> asked one of my senior managers to call them to discuss the exemption
> in relation to S-corporation stock (basically describing our
> transaction). They faxed us a couple of letters they received from
> the IRS with respect to their tax status. We have not had further
> discussions with them but I believe we owe a phone call to a person at
> the charity. My goal in this exercise was to find some of these
> entities -- since they do not have to rely on the NOL. Also, it could
> expand our ability to give to a wider array of charities. We also
> have a copy of the memo that was prepared by your group in WNT (see
> attached) and would obviously work with you to make sure that you
> could get comfortable with the 4958 issues prior to any specific
> discussions. Based on the concerns raised in the memo, I believe we
> could structure an appropriate transaction not much different than the
> transaction already approved. But prior to getting your group involved, I wanted to see
> if these entities (501c3s with 115 status) existed and from a practicable perspective
> whether they would even consider a gift of stock
> (besides tax concerns). The other important thing to note is that we
> mandate that any tax-exempt that considers accepting stock in SC2 get
> an outside opinion from legal counsel. This would also apply if we
> went forward with the 501c3s.
>
> I look forward to discussing this with you.
>
> Thanks,
>
> Larry
>
>
> << File: S-CAEPS_MEMO2.DOC >>
>
>
> -----Original Message-----
> From: Speizman, Richard A
> Sent: Wednesday, October 25, 2000 3:52 AM
> To: Manth, Larry E
> Cc: Springer, Mark A; DeLap, Larry
> Subject: SC2
>

Proprietary Material
Confidentiality Requested

Redacted by
Permanent Subcommittee
on Investigations

> Larry,
>
> I received a call yesterday from the tax manager assigned to the [REDACTED]
> [REDACTED], which is tax-exempt under
> section 501(c)(3). Apparently, [REDACTED] was approached by someone from
> KPMG involved in implementing the S corporation solution.
>
> As you may recall, at the time this solution was being approved, I
> had issues with the potential impact this solution might have on the
> tax exempt statuses of any section 501(c)(3) organizations that
> participated in one of these transactions, and the potential for
> intermediate sanctions excise tax liability. Rather than delay the
> rollout of the solution while we tried to resolve these issues, the
> decision was made to limit this solution to governmental pension
> funds, which do not have the same issues.
>
> Obviously, I am concerned that this section 501(c)(3) organization
> was contacted. I also suspect that this is not the first time this
> has happened (see the below string of correspondence).
>
> If we want to get section 501(c)(3) organizations involved in this
> solution, we need to address the issues raised. I would be happy to
> help however I can. Please let me know how you want to proceed.
>
> Best regards,
>
> Rick Speizman
> Exempt Organizations Tax Practice
> Washington National Tax
>
> Phone: (202) 533-3084
> Fax: (202) 533-8554
> E-mail: rspeizma@kpmg.com
>
> -----Original Message-----
> From: Springer, Mark A
> Sent: Tuesday, August 01, 2000 5:13 PM
> To: Speizman, Richard A
> Subject: RE: SC2-501(c)(3) orgs.with UBIT losses
>
> That is my understanding
>
> -----Original Message-----
> From: Speizman, Richard A
> Sent: Sunday, July 30, 2000 7:40 PM
> To: Chopack, John J
> Cc: Silver, Lawrence G; mspringe@kpmg.com
> Subject: RE: SC2-501(c)(3) orgs.with UBIT losses
>
> John and Larry,
>
> I assume you are asking with respect to the S corp solution. To the
> best of my knowledge, this solution has been approved only for
> governmental pension funds. Section 501(c)(3) organizations have
> issues with this solution that do not exist for governmental pension
> funds. I wasn't prepared to sign off on the solution at the time, so
> the decision was made to limit marketing to governmental pension
> funds.
>
> I am copying Mark Springer in case I am missing something here.
>
> I would be happy to discuss this with you further.
>
> Rick Speizman
> Proprietary Material
> Confidentiality Requested

3513



> KPMG LLP
> Washington National Tax
> Exempt Organizations Tax Practice
>
> Phone: (202) 533-3084
> Fax: (202) 533-8554
> Email: rspeizma@kpmg.com
>
> -----Original Message-----
> From: Chopack, John J
> Sent: Friday, July 28, 2000 11:29 AM
> To: Speizman, Richard A
> Cc: Silver, Lawrence G
> Subject: FW: SC2-501(c) (3) orgs.with UBIT losses
>
> Rick could you respond to Larry on this.
>
> -----Original Message-----
> From: Silver, Lawrence G
> Sent: Friday, July 28, 2000 11:23 AM
> To: Chopack, John J
> Cc: Manth, Larry E
> Subject: SC2-501(c) (3) orgs.with UBIT losses
>
> John: Could you ask Randy Dillon to get us a list of tax exempts with
> UBIT losses?(If such information is available and it should be) It
> would be an easier sell with this product to have a 501 c 3 hold the
> stock rather than a tax exempt municipal pension plan.For instance,
> [REDACTED] has a UBIT nol as does [REDACTED].I realize there is an
> AMT issue but the shareholders of the S corp could make a charitable
> contribution to the 501 c 3 to fund the entity's AMT.Your help would
> be greatly appreciated.Thanks.

Proprietary Material
Confidentiality Requested

KPMG 0015014

February 14, 2000

TO: Rick Rosenthal
KPMG/ LA

FROM: Bill Kelliher
KPMG/ WNT

RE: S Corp Charitable Contribution and Estate Planning Strategy ("S-CAEPS")

Rich Manfreda and I have reviewed the S-CAEPS strategy described and analyzed in the memorandum, dated February 3, 2000, prepared by Larry Manth, Andrew Atkin, Douglas Duncan and Robert Huber. We think that the general concept of the strategy has merit. However, we are concerned about several specific details, all of which relate directly or indirectly to questions of valuation.

1. Viewing all of the steps in the aggregate, the objective of the strategy appears to be to enable the sole shareholder of a "virgin" S corporation to:
 - Obtain a charitable contribution deduction equal to 10% of the total fair market value of the corporation by donating to a charity nonvoting stock representing a 90% ownership interest in the S corporation.
 - Achieve a transitory allocation of 90% of the S corporation's income to a charitable organization that would not be taxed on that income.
 - After a period of two years or more, have the S corporation redeem all of the stock of the charity for an amount equal to 10% of the fair market value of the S corporation.

2. Under this view, we have a 100% shareholder transferring 90% of his stock to an entity that will not be subject to tax and, at the same time, taking steps to ensure that the entity's interest can be reduced to 10% any time after two years. Then, at some point after two years elapse, all the entity's stock is redeemed for 10% of the value of the S corporation. Thereafter, the original shareholder owns 100% of the stock again.

2. Under the proposed structure, we have a concern that the IRS could recharacterize the overall transaction as either:
 - A contribution of a 10% stock interest in the corporation, rather than a 90% interest, in which case, the intended transitory allocation of 90% of the S corporation's income to the charity would be reduced to 10%; or
 - A sham under the rationale of the *Compaq* and *ACM* cases. The IRS could assert that the economic substance is that the charity is simply holding the non-voting stock as a nominee for the contributing shareholder. If so, 100% of the flow-through income of the S corporation would be allocable to the contributing shareholder. Under such a recharacterization, the charitable contribution of stock by the shareholder could be ignored and the redemption

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 126

KPMG 0047693

agreement could be viewed as a mere promise by the S corporation to contribute an amount to the charity at a future date.

3. Under the proposed structure, we are concerned that the IRS may have good grounds for challenging the charitable intent of the contribution to the charity. We agree with the memorandum's analysis that the charitable nature of the contribution could be challenged only if the IRS is able to show the existence of a *quid pro quo* transaction in which the donor receives consideration from the donee. However, we are concerned that, under the facts of the proposed transaction, the IRS would have a position that the donee's agreement to enter into a transaction that purports to shift to it 90% of the corporation's flow-through income for a period of two years or more, in exchange for a cash payment for doing so, constitutes consideration. In other words, the S corporation would be paying the charity approximately \$1 million to accept a transitory allocation of income that saves the shareholder approximately \$2.8 million (even ignoring the tax benefit of the charitable contribution deduction). Or, viewed the other way, the charity would be agreeing to relieve the shareholder of the burden of approximately \$2.8 million of tax on the shifted income, in exchange for a payment of \$1 million.

4. We are concerned that any valuation formula that so heavily discounts the non-voting stock could be subject to successful challenge by the IRS. For example, we have good reason to believe that a 35% discount factor may be acceptable to the IRS, but that a 50% discount would be very likely to be contested. Although we are not attempting to substitute our judgment for that of the appraisers, we do have some knowledge of what is acceptable to the IRS and what is not. If the IRS were to successfully challenge the 50% discount, the strike price of the warrants that would be issued to the shareholder to acquire the 7,000 shares of non-voting stock from the S corporation would be valued below 90% of their actual fair market value. In that event, the "safe harbor" protection under sec. 1.1361-1(l)(4)(iii)(C) of the one-class-of-stock regulations would be lost.

5. We are concerned about any valuation methodology that results in 90% of the stock of the corporation being redeemed from the charity for 10% of the value of the corporation. We believe that it invites a potentially successful IRS challenge to the claimed 90% shift in the allocation of the S corporation's taxable income from the contributing shareholder to the charity. This relates to the comments at Point 2, above.

6. We think that the memorandum's dismissal, on pg. 11, of the arguments raised by the IRS in *Compaq* and *ACM* in the context of this fact pattern may be a little too hasty. We are concerned that they could, indeed, be potentially applicable. There is an inconsistency between the valuation of the stock on redemption and the reduction of AAA following redemption. Specifically, AAA is reduced by 90%, creating the presumption that the warrants remain outstanding and are not taken into account in computing the percentage of stock redeemed. However, in valuing the stock held by the charity for purposes of the redemption, the valuation computation takes into account a deemed exercise of the warrants to reduce the valuation of the charity's stock. This

highlights the inconsistency in allocating 90% of the earnings of the S corporation to the charity, but only recognizing a 10% equity valuation for purposes of the redemption.

The bottom line is that, as currently structured, we have serious concerns about whether a more-likely-than-not opinion could be issued. We would be glad to discuss them with you and work with you to develop possible modifications that would satisfy our technical concerns without changing the objectives of the product.

3517

BLIPS
Bond Linked Issue Premium Structure
DRAFT 7/8/99

Who to Contact (The product targets individuals not corporations)
Individuals who have generated a capital gain of at least \$20 million.

The Call

My name is (name) and I am with the Big 5 Accounting firm of KPMG. May I take a moment of your time? I know you're busy, I'll be brief.

I would like to share some information with you regarding a KPMG financial planning strategy that may enable you to reduce tax on capital gain income. It could be applicable to you if you have already sold capital gain property in 1999 or if you are contemplating selling capital gain property in the future.

The parameters for this strategy are:

- a realized or expected capital gain of \$20 million.

Do you fall within this parameter?

If this sounds interesting to you, the next step is to arrange a short telephone conference for you with (name), one of our financial planning professionals. At that time, (name) will explain the benefits in your fact situation and help you determine if the strategy warrants your further consideration.

Are you available for a telephone meeting on (date) and (time) ?

What is the best # to reach you at that time?

M(r-s-s) _____, thank you for your time.

Benefits of BLIPS

- May enable an individual to avoid most of the associated tax on capital gain income for sales that have already taken place or that are contemplated to take place in the future.

Common Objections

Too risky. Too expensive. I do not have \$20 million in gain

- The risk associated with the strategy is commensurate with the benefit generated by the strategy.
- The cost of the strategy is competitive and reflects the significant benefit generated by the strategy.
- It will take just a few minutes of your time to learn more about the strategy from (name).

Proprietary Material
Confidentiality Requested

KPMG 0025670

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 130

The \$20 million gain threshold can be applied to a group of related parties.

**Proprietary Material
Confidentiality Requested**

KPMG 0025671

Postmaster: Please distribute the below message to ALL US PARTNERS (Assurance and ... Page 1 of 1

From: POSTMASTER-US
Sent: Thursday, March 14, 2002 7:56 AM
Subject: Sales Opportunity Center
DATE: March 14, 2002

TO: US Management Group

FROM: Tim Flynn - New York
 Jack Taylor - New York
 Rick Rosenthal - NSS/345 Park Avenue

CC: Ken Daly - Philadelphia
 Karen Schimpf - NSS/Montvale
 David Jones - New York
 Pat Neil - NSS/Montvale

SUBJECT: Sales Opportunity Center

The current environment is changing at breakneck speed, and we must be prepared to respond aggressively to every opportunity.

We have created a Sales Opportunity Center to be the "eye of the needle"—a single place where you can get access to the resources you need to move quickly, knowledgeably, and *effectively*.

This initiative reflects the efforts of Assurance (Sales, Marketing, and the Assurance & Advisory Services Center) and Tax (Marketing and the Tax Innovation Center), and is intended to serve as our "situation room" during these fast-moving times.

Among the types of support you can expect:

- Proposal assistance (templates, best practices, consultation),
- Assurance and Tax services information,
- Research assistance, and
- Sales coaching and support.

Effective immediately, you can access the resources available through the Sales Opportunity Center via a Hotline and Web site. The Hotline is manned with professionals who can answer your questions and help you identify relevant services, connect with the right people, and get the latest information about the Firm's position on current issues. Call 877-225-9035 from 8:00 a.m. to 8:00 p.m. Eastern Standard Time, Monday through Friday.

The Web site houses materials and links to templates, collateral, statistics, company research, and other resources you can use to make your pitch. [Click here](#) to access these tools and many more. Please note that you will be asked to register the first time you access the site by entering your full name and your KPMG e-mail address.

The Sales Opportunity Center is a powerful demonstration of the Firm's commitment to giving you what you need to meet the challenges of these momentous times. We urge you to take advantage of this resource as you pursue marketplace opportunities.

XX-000141

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 132

Message0110	
Subject:	SC2 - Follow-up to 1/29 Revisit
From:	Jones, David P (NY)
Date:	1/30/2001 9:22:14 AM
To:	Manth, Larry E
CC:	Rosenthal, Richard P; Klein, Wendy (NSS-Tax)
Message Body	
<p>Larry:</p> <p>To memorialize our discussion, we agreed the following:</p> <ul style="list-style-type: none"> * Over the next two weeks Manth will deploy Andrew Atkin to call each of the SC2 area solution champions. * Andrew will work with the champion to establish a specific action plan for each opportunity. To be at all effective, the plans should very specific as to who is going to do what when. * Getting the accurate solution status in OMS should be on the radar as an action step. * There should be agreement as to when Andrew will next follow-up with them to create a real sense of urgency and accountability. * Andrew will involve Manth where he is not getting a response within 24 hours or receiving inappropriate "pushback". Manth will enlist Jones or Rick to help facilitate responsiveness where necessary given the urgency of the opportunity. * Resource will be assigned to adequately address the market opportunity in the Midwest. * Manth believes inadequate resources are currently deployed to exploit the Midwest SCorp client and target population. Craig Pichette has not yet been able to dedicate enough time to this solution to effectively penetrate the client base (or target population). * Manth believes John Shrier (NE Stratecon) or Councill Leak (SE Stratecon) could be effective at penetrating the MW marketplace. John has had prior success in the MW and may be a better solution logistically. Councill is buried. * Jones will confirm Shrier's availability to focus on the MW marketplace. Shrier's goals must be adjusted with his performance manager and included in Dialogue including a percentage weighting based on expected time commitment. * Jones will discuss with Rick and seek to agree a plan to overcome any area boundary type issues (e.g., MW v. NE). * Resource will be assigned to adequately address the market opportunity in Florida. * There are a significant number of SCorps in Florida. Councill is busy chasing live situations and cannot adequately address the Florida market opportunity. * Manth will discuss situation with Atlee Harmon on Wednesday, 1/31. Manth will outline the specific criteria and time commitment of the person necessary for him/her to be effective. Could be partner or senior manager. Goals must be explicit and included in Dialogue including a percentage weighting based on expected time commitment. * Manth will execute and/or discuss with Jones if further options must be considered. <p>Manth will explore with Rick the opportunity to form alliances with other accounting firms to drive distribution. Conference on this topic is scheduled for today.</p> <p>Dave</p>	

Proprietary Material
Confidentiality Requested

KPMG 0050389

file:///W:/data/J06107583/710/WendyKlien%20HD%20Email/Message0110[52383].html

8/23/2003

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 135

David P. Jones
(212) 872-3255
(212) 872-6275 (Assistant - Carmen Calderon)
dpjones@KPMG.com

KPMG
36th Floor, 345 Park Avenue
New York, NY 10154

Outlook Header Information

Conversation Topic: SC2 - Follow-up to 1/29 Revisit
Subject: SC2 - Follow-up to 1/29 Revisit
From: Jones, David P (NY)
Sender Name: Jones, David P (NY)
To: Manth, Larry E
CC: Rosenthal, Richard P; Klein, Wendy (NSS-Tax)
Received By: Klein, Wendy (NSS-Tax)
Delivery Time: 1/30/2001 9:22:14 AM
Creation Time: 1/30/2001 9:22:14 AM
Modification Time: 1/31/2001 1:10:39 PM
Submit Time: 1/30/2001 9:22:14 AM
Importance: 1/1
Priority: 1/0
Sensitivity: 1/0
Flags: 1/1
Size: 1/7336

Proprietary Material
Confidentiality Requested

KPMG 0050390

3522

From: manni, Larry E
Sent: Tuesday, March 13, 2001 12:07 PM
To: Alvarez, Adele M; Atkin, Andrew S; Baumann, Dale R; Bendheim, Redge E; Bergmann, Jeffrey K; Black, Suzanne J; Bottini, Wayne F; Boyar, Adam W; Brown, Brad L; Busick, Ronald L; Choy, Susie K; Coughlin, Sean S; Cozart, Toby; Curtis, Gary L; D'Addio, Michael R; De La Hoya, Raquel M; DeCredico, David G; Dougherty, Timothy M; Duncan, Douglas P; Frimershtein, Oleg; Garigliano, Thomas; Gergen, Patricia A; Greenberg, David; Hacker, Barry C; Harrison, Mark E; Hirata, Masanori; Huber, Robert; Hutchison, Mark-Warner Cntr; Ida, Walter Y; Ito, Dennis A; Jackman, Thomas E; Kamahale, Dean B; Kreutzer, Conrad B; Lytle, Norman W; Maxfield, W B; McGrath, Michael W; Morris, Craig S; Murakami, Alton A; Orshansky, Anthony J; Pace, Kevin A; Perez, Frank; Pfatteicher, Linda E; Prager, Daniel; Robideaux, Robert W; Shen, Stephanie L; Sparkman, James; Tafoya, Angela M; Takaki, Cheryl M; Tom, Randall G; Turski, Douglas A; Walker, James D; Wilson, John H; Wise, Richard
Cc: Songey, Jim H; Midlock, Eugene J; Alfonso, Dale A; Stone, Michael E; Crawford, Russell W
Subject: Friday's Stratecon Call

This is a reminder that we will be having a call this Friday (March 16th) at 3 pm.

Due to the significant push for year-end revenue, all West Region Federal tax partners have been invited to join us on this call and we will discuss our "Quick Hit" strategies and targeting criteria.

A list of strategies will be sent prior to the call.

Thanks,

Larry

CALL DATE: MAR-16-2001 (FRIDAY)
CALL TIME: 3 PM PACIFIC TIME
TOLL FREE NUMBER: 877-915-4783
PASSCODE: 83658

XX-001439

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 138

KMatch Push Feature Campaign

Marsha Peters
Tax Innovation Center

FOR INTERNAL USE ONLY ...
NOT TO BE USED FOR CLIENT PRESENTATIONS

XX-001511

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 141

What is KMatch?

- An interactive software program that asks a user a series of questions about a client's business and tax situation
- KMatch logic sorts through the answers to identify *Tax Solution Alerts* and *Tax Service Ideas* that likely are appropriate for the client

V

2

KMatch Capabilities

- Pull technology – allows professionals to search the KMatch database for solutions and ideas
- Push technology (NEW) – sends solutions and ideas to professionals' desktops

V

3

XX-001513

How the Push Feature Works

- After a KMatch user answers questions and saves client data, he/she is notified by email of new solutions and ideas that match the client's profile.
- Similarly, we can "push" previously posted solutions and ideas that the tax practice wants to promote, e.g.:
 - Special initiatives, such as cash flow drive period strategies
 - Year-end strategies
 - "Revisited" Solutions

V

4

Campaign to Get Client Data into KMatch

- Recommended for all clients
- Required by 1/15 for:
 - Americas Accounts
 - Priority Area Accounts
 - Other accounts with annual tax consulting fees > \$100K
- Progress report to AMPs/BUPICs in early January

V

5

XX-001515

What Should You Do

- Enter Basic Client Data
 - > Type of entity
 - > Industry
 - > Select "all areas of practice"
 - > Select all relevant business issues
- Answer Questions
 - > Not required, but answering questions allows KMatch to more accurately filter new solutions and ideas
- Save file as the "push" file
 - > Use other KMatch data files for the same client to target specific business issues or areas of practice
- Enter email address for team member to be notified of pushed solutions and ideas

V
6

Should You Have Questions or Problems

- For questions about the KMatch technology, call the KPMG Help Desk
- For questions or comments about the KMatch content, email the US-Tax Innovation Center inbox

V

7

XX-001517

Targeting Parameters: Intellectual Property Services--Assurance and Tax	7/17/00
Targeting Methodology: The second tab of this file contains the draft target list. It's sorted by KPMG area.	
This list was compiled from two sources an assurance and tax list. The tax list was compiled from companies with research and development expenditures >\$10 million from the 10(k)s. The Intellectual Property Services team list was compiled from their recent direct mail based on companies which filed numerous patents. The lists were compared to select the companies that appeared on both. The results were 84 overlapping companies. To narrow the prospects further, we selected the companies which are assurance or tax clients, which resulted in the 45 companies on the next sheet.	
Target List Criteria: --Sorted by KPMG area and Company	
Tax List -Companies with >\$10 Million R&D Expenditures and are an audit or tax client; and	
Assurance List -Companies which file numerous patents in one year and are an audit or tax client	
The resulting companies met the above criteria and appeared on both Practice's target list.	
Next Steps: Review list to determine if any of the companies are nonviable to jointly target, or add companies that are not currently listed.	

Joint Marketing Target List

3531

- List contains 115 suspects for you to consider
- Results were compiled from two sources
 - **Tax:** Companies with >\$10 Million R&D Expenditures and are audit or tax clients
 - **Assurance/IP Management:** Companies with large patent portfolios, have been leaders in filing new patents in recent years, or make a substantial investment in R&D
- What should you do?
 - Review the suspects with your assurance or tax deployment counterpart
 - Provide additional prospects or inform us if some companies are nonviable
 - Prioritize your area targets, and plan how to approach them

XX-001568

3532

Intellectual Property Services

September 2000

XX-001569

Marketing Objectives

- To increase KPMG's market penetration of key clients and targets by enhancing the linkage between Assurance and Tax professionals.
- To create excitement among our professionals regarding the enhanced opportunities a joint approach (Tax and Assurance) will yield.

Marketing Strategies

- To alert KPMG professionals (tax and assurance) of our joint solution development and deployment efforts.
- Announce the launch of our first joint solution, Intellectual Property Services, and encourage professionals to identify viable prospects.
- Create distinct communication vehicles to telegraph to our professionals that these joint initiatives are unique.
- Piggyback on existing tax and firm communications vehicles, such as *InfoTax* and *InfoTrack*, to reinforce the tax/firm's leadership's commitment to joint solution development.

Target Audience**Internal Program**

- Tax and Assurance Professionals

Program Tactics

Deliver frequent messages to tax and assurance professionals to raise their awareness of and encourage them to identify prospects and/or recommend KPMG's Intellectual Property Services services.

Program	Timing	Brief Description
Communications		
Formal e-mail announcement	September	email from Terry Strange and Jeff Stein to all tax and assurance professionals reinforcing leaderships' commitment to an integrated solution development and deployment initiative. Highlight Intellectual Property Services roll out.
<i>InfoTax</i>	September	Special issue: provide an overview of Intellectual Property Services
<i>InfoTax</i>	Ongoing	Short submissions regarding new developments in Intellectual Property Services including: success stories, service enhancements, etc.
<i>InfoTrack</i>	September	Brief announcement of our joint solution development and deployment efforts. Feature Intellectual Property Services as the first integrated effort.

Program	Timing	Brief Description
Articles in Area newsletters	Ongoing	Highlight Intellectual Property Services in local news and national initiatives (e.g. new hires, success stories).
<i>Assurance Transformation</i>	September	Announcement of our joint solution development and deployment efforts. Feature Intellectual Property Services as the first integrated effort.
<i>Assurance Transformation</i>	Ongoing	Continuous newsflashes providing success stories and progress on the collaboration.
LOB Newsletters	Fall	Industry tailored articles regarding opportunities for selling joint solutions to national accounts.
Marketing Initiatives		
Monday Night Call	September	Formal rollout on Monday Night call to all tax and assurance partners. Special invite extended to Assurance to join the call. Joint presentation by assurance and tax.
Tax Solutions Alert	September	Create a Tax Solutions Alert for reference. Include in the toolkit.
Distance Learning Sessions	September	High level training to educate deployment team on the underpinnings of the service offering. Periodic Monthly Innovative Tax Solutions sessions for all tax professionals.
Deployment Team Calls	Every 2 weeks initially	Share success stories and best practices. Communicate additional support needs to Development Team, sales, and Marketing
Joint Area Sales Meetings	Ongoing	Intellectual Property Services team members to address local tax and assurance partners at key area sales meetings.
BDM Tutorial	October	Intellectual Property Services assurance and tax leaders to conduct BDM tutorial to enroll their assistance in prospecting.

3536

Program	Timing	Brief Description
Practice Development Coordinators	Consider using after measuring results from 2 months of activity	Provide assistance in securing phone appointments for the team.
Research Support		
Target List Refinement	Ongoing	Internal research to prepare target lists, ebooks and provide continuous information on targeted industries.

**Intellectual Property Services
National Deployment Team**

Practice	Assurance	Tax
National Team Leaders	<p>Joe Zier, National Deployment Champion 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>Dut LeBlanc, National Deployment Champion 10071 Winding Ridge Drive Shreveport, LA 71106 318-673-1229 dleblancjr@kpmg.com</p> <p>Don Chung, ICS/IHCo Silicon Valley Office (650) 404-5000 dchung@kpmg.com</p> <p>Rob Lang, SALT/STM 816 Lucky Clover Lane Murray, Utah 84123 (801) 237-1329 rgland@kpmg.com</p> <p>Sharon Katz-Pearlman, TCS 40 East 84th street, Apt. 4D New York, NY 10028 (212) 872-6084 skatzpearlman@kpmg.com</p>
MA	<p>Joe Zier, National Deployment Champion 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>John T. Shano, Partner, Federal Tax 1410 A Malvern Avenue Baltimore, MD 21204 (410) 783-8379 ishano@kpmg.com</p>
NE	<p>Joe Zier, National Deployment Champion 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>Anthony (Tony) Alexandrou, Partner International Services 2 Perry Court Armonk, NY 10504 (212) 872-5891 analexan@kpmg.com</p>

XX-001574

Last printed 11/12/2003 5:18 PM

M:\PSATaxes\6 files MASTER\CS2\20030423\KPMG Data CD2\Solutions (1 of 2) as of 1-17-02\IN PROCESS\ASSURANCE-TAX\INTELLECTUAL PROPERTY SERVICES\TEAM\IP SERVICES LEADER MATRIX.DOC

SE	<p>Joe Zier, National Deployment Champion 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>Tammy Hunter, Senior Manager, SALT 303 Peachtree Street, NE Atlanta, GA 30308-3210 (404) 222-3000 thunter@kpmg.com</p>
SW	<p>Joe Zier, National Deployment Champion 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>Richard "Dick" Coshow, Partner, SALT 2016 Winding Hollow Lane Plano, Texas 75093 214-840-2177 rcoshow@kpmg.com</p> <p>Carla Howard, Fed Tax (?)</p>
W	<p>Joe Zier, National Partner, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>Janet S. Wong, Partner, SALT 30 Stockbridge Avenue Atherton, CA 94027 (650) 404-5383 js Wong@kpmg.com</p>
MW	<p>Joe Zier, National Partner, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4915</p> <p>Steve Acosta, Managing Director, IPS 303 East Wacker Drive Chicago, IL 60601 (312) 665-1000</p> <p>Russell Wiefling, National BDM, IPS 500 East Middlefield RD Mountain View, CA 90046 650-404-4914 rwiefling@kpmg.com</p>	<p>Duncan Forsythe, Partner, ICE 2806 Shannon Northbrook, Illinois 60062 312-665-5124 dforsythe@kpmg.com</p> <p>XX-001575</p>

3539

XX-001576

Last printed 11/12/2003 5:18 PM
M:\PS\Taxes\files MASTER\CS2\20030423\KPMG Data CD2\Solutions (1 of 2) as of 1-17-02\IN PROCESS\ASSURANCE-
TAX\INTELLECTUAL PROPERTY SERVICES\TEAM\IP SERVICES LEADER MATRIX.DOC

INTELLECTUAL PROPERTY SERVICES TEAM LIST**Kurt Beyer**

Product Manager at Assurance & Advisory Service Center—Forensic & Litigation Services
 NSS – Montvale
 Three Chestnut Ridge Road, Building 7
 Montvale, NJ 07645-0435
 201.505.2008

Role(s): Working with Tara on the revisions to the white paper and the training session for the area champions.

Roger D. Carlile

Assurance & Advisory Services—Forensic & Litigation Services
 National Partner in Charge—Forensic & Litigation Services

KPMG – Dallas
 Suite 300
 200 Crescent Court
 Dallas, TX 75201-1885
 214.840.2415

Role(s): Co- National Deployment Champion - Assurance

Donald D. Chung

Tax Services—International Services – International Corporate Tax Services
 KPMG – Century City
 Suite 1100
 1999 Avenue of the Stars
 Los Angeles, CA 90067-6036
 310.551.6187

Role(s): National Team Leader Tax IHC and ICS

Sharon D. Katz-Pearlman

Tax Services—Tax Controversy
 Northeast Partner in Charge—Tax Controversy Services
 KPMG – New York
 757 Third Avenue
 New York, NY 10017
 212.872.6084
 212.954.7527

Role(s): Direct link with Tax Controversy Services

Wendy Klein (NSS-Tax)

Partner – Tax Operations
 KPMG – New York
 345 Park Avenue
 New York, NY 10154
 212-872-6515

XX-001577

Role(s): Coordinate marketing efforts including targeting, external awareness building programs, etc.

Robert G. Lang, Jr.

Tax Services—State and Local Tax
 KPMG – Salt Lake City, Suite 900
 60 East South Temple
 Salt Lake City, UT 84111-1004
 801.237.1329
 415.951.7841

Role(s): National Team Leader Tax SALT/STM

Donald H. "Dut" LeBlanc, Jr.

Tax Services—Federal Tax – Financial Services
 KPMG – Shreveport
 Suite 1900
 333 Texas Street
 Shreveport, LA 71101-3692
 318.221.7133

Role(s): National Deployment Champion – Tax

Marie Fortier

Director, Intellectual Property Services
 Houston Texas & Silicon Valley Office
 713.319.-2801

Role(s): Business Development, Marketing & Targeting

Colleen A. Moore

Marketing Director for the Tax Innovation Center--Washington National Tax
 KPMG – WNT
 2001 M Street, NW
 Washington, DC 20036
 202.533.5484

Role(s): Marketing & Targeting

JonathAn C. Pullano

Area Marketing Director for the Southwest—Tax
 KPMG – Dallas
 Suite 300
 200 Crescent Court
 Dallas, TX 75201-1885
 214.840.4055

Role(s): implement targeting and marketing in the Southwest

XX-001578

Susan C. Rucker

Assurance & Advisory Services—Assurance & Advisory Services Center (AASC)
 Partner in Charge, Product Development—Assurance & Advisory Services
 NSS – Montvale
 Three Chestnut Ridge Road

Montvale, NJ 07645-0435
201.307.7228

Role(s): Authorizes AASC resources to work on projects, and helps with coordination of other staff resources within the firm .

Anastasia I. Savas

National Marketing Director – Assurance – Forensic & Litigation Services
NSS – Montvale
530 Chestnut Ridge Road
Woodcliff Lake, NJ 07675

Role(s): Marketing and Targeting

Tara C. Sirmans

Tax Services – Washington National Tax
Manager – Tax Innovation Center
KPMG - WNT
2001 M Street, N.W.
Washington, DC 20036
202.533.4370

Role(s): TIC Manager

Mark A. Springer

Tax Services—Washington National Tax
National Partner in Charge—Tax Innovation Center
KPMG – WNT
2001 M Street, N.W.
Washington, DC 20036
202.533.3076

Role(s): TIC Leader

Russell A. Wiefeling

National BDM, Intellectual Property Services
KPMG – Silicon Valley (Mountain View- CA)
500 East Middlefield Road
Mountain View, CA 90046
650.404.4914

Role(s): IPS Business Development Manager - Assurance

Joachim H. R. "Joe" Zier

Assurance & Advisory Services—Forensic & Litigations Services
National Director of Intellectual Property Services
KPMG – Silicon Valley (Mountain View- CA)
500 East Middlefield Road
Mountain View, CA 90046
650.404.4915

XX-001579

Role(s): Co-National Deployment Champion - Assurance

Intellectual Property Services (IPS)

Dut LeBlanc, Shreveport
Joe Zier, Silicon Valley
October 30, 2000

3543

XX-001580

**FOR INTERNAL USE ONLY --
NOT TO BE USED FOR CLIENT PRESENTATIONS**



Solution Profile

- ◆ Collection of assurance and tax services designed to assist companies in identifying, enhancing, protecting, and realizing value from their intellectual property
- ◆ Delivered by joint team of KPMG assurance and tax professionals with industry experience and specialized knowledge related to intellectual property

XX-001581



For Internal Use Only

Solution Profile

◆ Assist clients in:

- Gaining a deeper understanding of their intellectual property structure and value
- Making better decisions regarding their R&D efforts
- Improving their speed to market and competitive advantage
- Recognizing financial benefits from their underutilized intangible assets
- Reducing their overall cost of capital
- Significantly reducing their federal and foreign income tax liability and generate income tax savings in select states

XX-001582



For Internal Use Only

Scope of Services Include:

- ◆ Assist client in performing an inventory of its intellectual property
- ◆ Assist client in determining and implementing the best method to extract value from its intellectual property
- ◆ Recommend to client deployment strategies and alternative uses of its intellectual property

XX-001583



For Internal Use Only

Target Characteristics

- ◆ A company with one or more of the following characteristics:
 - Actual or projected sales > \$100 million
 - Multiple worldwide divisions
 - Undertaking rapid technological innovation
 - Intensive R&D focus to maintain competitive advantage
 - Numerous registered patents and trademarks
- ◆ Typical buyer is CEO, CFO, or COO

XX-001584



For Internal Use Only

Service Delivery / Pricing

- ◆ Delivery will generally be four-phased:
 - Inventory
 - Assessment
 - Strategy
 - Deployment
- ◆ Fixed fee or value-added dependent on specific services delivered during the phases

XX-001585



For Internal Use Only

Teaming with Assurance

- ◆ Teaming with Assurance expands tax team's knowledge of client and industry
- ◆ Demonstrates unified team approach that separates KPMG from competitors
- ◆ Provides target with complete menu of KPMG services

XX-001586



For Internal Use Only

National Deployment Team

◆ National Champions

- *Dut LeBlanc (Shreveport) - Tax*
- *Joe Zier (Silicon Valley) - Assurance*

◆ National Deployment Team

- *Don Chung (Silicon Valley) – Tax*
- *Brett Gold (New York) – Tax*
- *Rob Lang (Salt Lake City) – Tax*
- *Sharon Katz-Pearlman (New York) – Tax*
- *Dan Peters (Short Hills) - Tax*
- *Steve Acosta (Chicago) Assurance*
- *Terry Bradford (Washington D.C.) - Assurance*
- *Russell Wiefeling (Silicon Valley) - Assurance*



For Internal Use Only

Service Delivery – Area Resources

- ◆ **Northeast**
 - *Anthony Alexandrou (New York) – Tax*
 - *Joe Zier (Silicon Valley) – Assurance*
 - *Steve Acosta (Chicago) Assurance*
 - *Russell Wiefeling (Silicon Valley) - Assurance*
- ◆ **Midatlantic**
 - *John Shano (Baltimore) – Tax*
 - *Joe Zier (Silicon Valley) – Assurance*
 - *Steve Acosta (Chicago) Assurance*
 - *Russell Wiefeling (Silicon Valley) - Assurance*

XX-001588



For Internal Use Only

Service Delivery – Area Resources

◆ Area Resources

- Southeast
 - » *Tammy Hunter (Atlanta) – Tax*
 - » *Joe Zier (Silicon Valley) – Assurance*
 - » *Steve Acosta (Chicago) Assurance*
 - » *Russell Wiefeling (Silicon Valley) - Assurance*
- Midwest
 - » *Duncan Forsythe (Chicago) – Tax*
 - » *Joe Zier (Silicon Valley) – Assurance*
 - » *Steve Acosta (Chicago) Assurance*
 - » *Russell Wiefeling (Silicon Valley) - Assurance*

3552

XX-001589



For Internal Use Only

Service Delivery – Area Resources

◆ Area Resources

- Southwest
 - » Richard Coshow (Dallas) - Tax
 - » Carla Howard (Dallas) – Tax
 - » Joe Zier (Silicon Valley) – Assurance
 - » Steve Acosta (Chicago) Assurance
 - » Russell Wiefeling (Silicon Valley) - Assurance
- West
 - » Janet Wong (Silicon Valley) – Tax
 - » Joe Zier (Silicon Valley) – Assurance
 - » Steve Acosta (Chicago) Assurance
 - » Russell Wiefeling (Silicon Valley) - Assurance

3553

XX-001590



For Internal Use Only

KPMG's Strength

- ◆ KPMG's differentiator is a more comprehensive business solution delivered jointly by assurance and tax professionals
- ◆ Few competitors can offer a comparable portfolio of intellectual property services
- ◆ KPMG's experienced professionals understand the issues facing our clients and have devised solutions in a variety of environments

XX-001591



For Internal Use Only

Toolkit Documents

- ◆ Sample client presentation
- ◆ Sample engagement letter
- ◆ Internal solution overview presentation
- ◆ Whitepaper
 - Please note that printed copies of the whitepaper are available for distribution to clients and targets. Copies can be obtained from Diane Kiffin Nardin who can be contacted via phone at 404-371-8676 or via email at dkiffin-nardin@kpmg.com.

XX-001592



For Internal Use Only

What You Should Do

- ◆ Review the initial target list that has been provided to the deployment team members and all tax partners
- ◆ Identify clients or targets that meet target characteristics
- ◆ Contact member of national deployment team to introduce Intellectual Property Services to clients and targets

XX-001593



For Internal Use Only

Innovative Tax Solutions September 19, 2002

Mark Springer

Washington National Tax

3558

**Redacted by the
Permanent Subcommittee
on Investigations**

XX-001636-1652

New Enterprises Tax Suite (Tax Solution Alert 00-31)

Tom Hopkins
Silicon Valley



Value Proposition

XX-001654

- New Enterprises Tax Suite is a cross-functional element of the Tax Practice that efficiently mines opportunities in the start-up and middle-market, high-growth, high-tech space
- Serves as a significant point of entry from start-up space into the middle market, and eventually the KPMG 1400
 - Supports national tax strategy of middle market growth
 - Support firm's strategic business development initiatives
- On an absolute basis, high tech investment is down from the top in 2000, but relatively strong as compared to 1998

3560

3561

**Redacted by the
Permanent Subcommittee
on Investigations**

XX-001654

Integration with Assurance

959100-XX

- Teaming with Assurance (1Start in the West with variants in other geographies) and integrating with KPMG professionals previously with Andersen's Enterprise Practice expands the client and industry knowledge of the delivery team while fostering cross-selling among assurance and tax professionals
- This coordinated approach creates a unified team that helps distinguish KPMG from its competitors and provides companies with a more complete menu of services

3562

3563

Redacted by the
Permanent Subcommittee
on Investigations

XX-001657

Critical Success Factors

859100-XX

- Integrate successfully with Assurance
- Differentiate KPMG from other Big 5 on issues besides price
- Develop and use client selection filters to refine our bets and reach higher market success
- Leverage existing client base (pull-through) including new clients/targets from Andersen
- Continue to work with WNT and TIC to enhance solutions (e.g., Tax Loss Consulting Services)
- Enhance relationships with client decision makers

3564

3565

Redacted by the
Permanent Subcommittee
on Investigations

XX-1659-1660

Deployment Action Plan

199100-XX

- Focus targeting efforts in West, Northeast, & Midatlantic
- Partners with revenue goals are given subscriptions to *Venture Wire* for daily lead generation in respective areas
- Targeting is supplemented by daily lead generation from Fort Wayne
- Fort Wayne arranges ICVs for hot companies (Red Herring/Upshot campaign)
- Respond opportunistically to prospects presented to us through Venture Capital firms and other relationships

3566

3567

Redacted by the
Permanent Subcommittee
on Investigations

XX-1662-1706

Post-Transaction Integration Service (PTIS) -- Tax

Stan Wiseberg, Washington, D.C.
Michele Zinn, Washington, D.C.
March 6, 2000

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 150

FOR INTERNAL USE ONLY --
NOT TO BE USED FOR CLIENT PRESENTATIONS



3569

Redacted by the
Permanent Subcommittee
on Investigations

XX-1598

Profile

66S100-XX

- ◆ Global collaborative service brought to market by tax and assurance
- ◆ May be appropriate to initially unbundle the services (“tax only,” or “assurance only”) to capture an engagement
 - responsibility of the first group to bring other practices into the engagement

3570



© 2000 KPMG LLP. All rights reserved. Private and Confidential.

3571

Redacted by the
Permanent Subcommittee
on Investigations

XX-1600-1611

3572

DATE: August 14, 2001
TO: KPMG LLP Partners, Managers and Staff
FROM: Jeff Stein - NSS/345 Park Avenue
Walter Duer - Houston
SUBJECT: Stratecon Middle Market Initiative

Consistent with several other firm initiatives involving market leaders, we are launching a major initiative in Tax to focus certain of our resources on the Middle Market. A major step in this initiative is driving certain Stratecon high-end solutions to these companies. Seven Stratecon solutions together with FSG solutions have been identified to drive into the Middle Market through a structured, proactive program.

Captive Tune-up	WITS
Gain Mitigation	Hamlet
Structured Finance	SLOTS
SC2	

Stratecon will be working closely with the newly formed Federal Solutions Group to coordinate solutions such as CLAS, TAS, and R&E credits as both Stratecon and Federal Solutions Group will focus on Middle Market opportunities.

National and area champions of this initiative will meet with leadership in each area to discuss solutions, agree on appropriate targets, and develop an area strategy for teeing up ICVs and sales cycle follow-up. This initiative will integrate existing Middle Market programs through development and implementation of consistent targeting and marketing. In order to maximize marketplace opportunities and leverage this initiative, national and area champions will coordinate with and involve assurance partners and managers in their respective areas. National and area champions will also coordinate with the tax practice's proposed strategic alliance with mid-tier accounting firms. The goal for Stratecon is to close and implement engagements totaling \$15M in revenues over the next 15 month period (FY ending 9/02).

The national champions for this initiative are Renee Knilians (New York) and Todd Voss (Chicago). The area champions are:

- Mike Mathisen - MA
- Bob Pence - MW
- Steve Goldberg - NE
- Councill Leak - SE
- Mike Terracina - SW
- Larry Manth - W

Detailed training for the Stratecon champions took place on August 13. A more detailed overview of this initiative will be presented during the Tax Innovation Center's August 16 Innovative Tax Solutions Distance Learning session. You are encouraged to participate in this Distance Learning and become a participant in this all important Middle Market Initiative.

Proprietary Material
Confidentiality Requested

KPMG 0050369

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 151

Message0050	
Subject:	SC2 revisit of stale leads
From:	Jordan, Ty N
Date:	2/9/2001 10:42:17 AM
To:	Parker, Paul C; Otto, Richard D; Crew, Gary A; Fussell, Larry W; Bouterse, Ronald; Donihi, Tim M; Roth, Robert J
CC:	Leak, Council; Fowler, Jamie B
Message Body	
<p>All,</p> <p>Attached above is a listing of all potential SC2 engagements that did not fly over the past year. In an effort to ensure we have not overlooked any potential engagement during the revenue push for the last half of fye 2001, please review the list which is sorted by estimated potential fees. I'd like to revisit each of these potential engagements, and gather comments from each of you regarding the following. I'll contact each of you within the next 4 business days. If you have any suggestions, please feel free to respond via email if you had direct involvement with any potential target.</p> <ol style="list-style-type: none"> 1. Would further communication/dialogue with any listed potential engagement be welcome? What were the reasons for the potential client's declining the strategy? 2. We now have a number of Insurance companies which would like to underwrite the tax risk inherent in the transaction. We may want to revisit those potential clients that declined because of audit risk. 3. We may be able to leverage off of firm partners (TSPs) that were more eager to push the strategy. I'll need your help in identifying those internal firm resources. 4. Several new enhancements to the original SC2 strategy are being developed so that we may introduce SC2 to a new group of targets, or revisit cold leads. One of the enhancements relates to the use of a community trust. This variation may be appropriate to revisit with targets that declined because they did not like the choice of tax-exempts available to which a contribution would be made. <p>Ty Jordan 404-979-2131 direct dial 404-751-6161 confidential facsimile KPMG Atlanta 303 Peachtree St. Ste. 2000 Atlanta, GA 30308 *****</p> <p>Our conclusions are limited to the conclusions specifically set forth herein and are based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations are not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof. *****</p>	
Attachment	
SE SC2 2-6 by Fee.xls	
KPMG 0050814	
Proprietary Material Confidentiality Requested	<div style="border: 1px solid black; padding: 2px;"> Permanent Subcommittee on Investigations EXHIBIT #155 - FN 152 </div>

3574

Outlook Header Information

Conversation Topic: SC2 revisit of stale leads
Subject: SC2 revisit of stale leads
From: Jordan, Ty N
Sender Name: Jordan, Ty N
To: Parker, Paul C; Otto, Richard D; Crew, Gary A; Fussell, Larry W; Bouterse, Ronald; Donihi, Tim M; Roth, Robert J
CC: Leak, Council; Fowler, Jamie B
Received By: Leak, Council
Delivery Time: 2/9/2001 10:42:17 AM
Creation Time: 2/9/2001 10:07:09 AM
Modification Time: 2/9/2001 10:42:17 AM
Submit Time: 2/9/2001 10:42:16 AM
Importance: 2/2
Priority: 2/1
Sensitivity: 2/0
Flags: 2/17
Size: 2/47520

Tom Newman
08/30/99 03:01 PM

To: Tom Newman/Corp/FirstUnion@FirstUnion, Jeff Martin/Corp/FirstUnion@FirstUnion, John Castrucci/CMG/USR/FTU@FTU, Lisa Feathergill/Corp/FirstUnion@FirstUnion, Roger Scheffel/CMG/USR/FTU@FTU, Teri Sallwasser/CMG/USR/FTU@FTU, Rick Simonetti/CMG/USR/FTU@FTU, Barry Levin/CMG/USR/FTU@FTU
cc: Diane Stanford/Corp/FirstUnion@FirstUnion
Subject: next strategy

Strategy Update.

Just wanted to let you guys know that a KPMG investment/tax strategy which KPMG shared with Jeff Martin and myself was voted and approved by the due diligence subcommittee last week. This means that the Risk Oversight Committee will have this particular strategy on its agenda at its Wednesday meeting. Jeff and I will make a presentation to the Risk Oversight Committee at this meeting for final approval. The strategy will serve to offset either ordinary income or capital gains (\$20 million minimum).

There are several critical points that should be noted with respect to this strategy if we get it approved. Many of these points relate to Sandy Spitz' concern (and KPMG's concern) that First Union has a very high profile across our franchise for being associated with "tax" strategies; namely, FLIP and BOSS. Sandy does not want this kind of high profile to be associated with this new strategy.

In order to address some of Sandy's concerns and lower our profile on this particular strategy, the following points should be noted:

- * The strategy has an KPMG acronym which will not be shared with the general First Union community. We will probably assign a generic name which may actually be used for all strategies of a particular type. We should never use the KPMG acronym with private bankers, trust specialists, and others within First Union.
- * Our traditional sources of client referrals inside First Union should not be informed of which Big 5 accounting firm we will choose to bring in on a strategy meeting with a client. I'm sure the client may eventually tell the private banker or trust specialist that they were in a meeting with either KPMG or PWC, but we should avoid telling our referral sources directly.
- * No one-pager will be distributed to our referral sources describing the strategy. We can of course continue to inform referral sources about minimums, type of income offset, other general info.
- * All questions regarding this particular strategy should be directed to Sandy Spitz. Under no conditions are we to have either internal referrals, or clients, calling a local KPMG partner.
- * Fees to First Union will be 50 basis points if the investor is not a KPMG client, 25 bps if they are a KPMG client.
- * Similar to our old FLIP strategy offered last year, we will have to have clients sign a First Union engagement letter. David Hebner has reviewed the engagement letter once again and I have a new template for your use.

I have written up a technical summary of the tax opinion since Sandy will only allow us to read a draft copy of the opinion in his office without making a copy. I also have a step-by-step summary of the strategy which is not in diagram form but will still help you familiarize yourself with the strategy. I will be glad to share these with you once the Risk Oversight Committee has approved the strategy.

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 154

SEN-014622
SEN-014623

Message0020	
Subject:	FW: First Union Customer Services
From:	Leak, Councill
Date:	11/30/2001 11:11:33 AM
To:	Manth, Larry E
Message Body	
<p>Larry, here's the e-mail I mentioned in my VMX this morning. Call me to discuss.</p> <p>Councill</p> <p>J. Councill Leak Partner, Federal Tax Services/Stratecon Practice kpmg LLP, Charlotte, NC Direct: 704.371.8135 Fax: 704.335.5377 Cell: 704.906.4520 e-mail: cleak@KPMG.com</p> <p>Our conclusions are limited to the conclusions specifically set forth herein and are based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.</p> <p>The information in this email is confidential and may be legally privileged. It is intended solely for the addressee. Access to this email by anyone else is unauthorized. If you are not the intended recipient, any disclosure, copying, distribution or any action taken or omitted to be taken in reliance on it, is prohibited and may be unlawful. When addressed to our clients any opinions or advice contained in this email are subject to the terms and conditions expressed in the governing KPMG client engagement letter</p> <p>-----Original Message----- From: Leak, Councill Sent: Thursday, March 29, 2001 3:35 PM To: Ritchie, Lewis R Subject: FW: First Union Customer Services</p> <p>Lewis, as discussed, I provide my comments on how we are bringing SC2 into certain First Union customers. Please review and let's discuss to insure we are within the bounds of KPMG's independence rules.</p> <p>-----Original Message----- From: Brawley, David F Sent: Friday, February 23, 2001 2:51 PM To: Leak, Councill Subject: FW: First Union Customer Services</p> <p>Councill: See the bottom of this message that discusses the 10 points of light. Also, please refer to Tax PPL 00-04 which is more current and also discusses the 10 requirements.</p>	

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 154

KPMG 0050842

-----Original Message-----

From: Guinan, John M
Sent: Tuesday, March 30, 1999 7:45 AM
To: Spitz, William L; Conway, Michael A; DeLap, Larry; Licari, Jerry R; Brawley, David F; Seiden, David M
Subject: RE: First Union RFP

The summary captures the final points raised in our discussion.

-----Original Message-----

From: Spitz, William L
Sent: Monday, March 29, 1999 4:31 PM
To: Conway, Michael A; Guinan, John M; DeLap, Larry; Licari, Jerry R; Brawley, David F; Seiden, David M
Subject: First Union RFP

Proprietary Material
Confidentiality Requested

KPMG 0050843

Gentlemen:

The following is a summary of the conclusions and related stipulations that resulted from our conference call this morning. I would appreciate your comments regarding the following if you find it to be in any way inaccurate. Background information related to the details of the RFP are attached including a corrected letter to Larry Delap dated March 24, 1999 that summarizes KPMG's services envisioned by the RFP as well as correspondence with Larry Delap that discusses various issues associated with those services.

In the conference call, we concluded that our services envisioned under the terms of the RFP would not impair independence as long as the following holds true:

- 1) KPMG must become one of several qualified providers/advisors based on some prequalification criteria. Client will be provided with other providers, including other Big 5 and boutique firms, that offer solutions that provide similar results to SC2.
- 2) First Union must provide the customer more than one advisor to choose from when KPMG is presented to the customer as a possible advisor. [] [] First Union will present other providers of similar solutions for the customer to choose from.
- 3) The customer must select the advisor (not First Union). [] [] The client will make the choice of using KPMG or not for the specific solution. They will be presented competing alternatives from other advisors from which they may choose.
- 4) If KPMG is selected by the client, KPMG must go through its normal client evaluation process as well as its normal due diligence process in order to develop information. [] [] If KPMG is selected by the client it will go through its normal client evaluation and due diligence process.]
- 5) The customer must be made aware that the service (strategy) could be delivered without First Union. [] [The client will be made aware that the solution ([] SC2) could be delivered without First Union. First Union will offer to perform the appraisal aspect of the engagement [] and will offer to help the customer structure it's investment plan during the course of the solution timeframe ; the client will be free to choose among alternative providers of [] these services.]
- 6) KPMG must issue its own engagement letter and with no price dependency on other parties (i.e. First Union). [] [KPMG if engaged, will issue its own stand-alone engagement letter with no price dependency on other parties.]
- 7) If KPMG's fee will be reduced for work performed by other parties, that reduction must be based on reasonable guidelines, and the engagement letter must spell out the work that will be performed by KPMG as well as other parties in accomplishing the required tasks. [] [KPMG's engagement letter will spell out the work that will be performed (and by whom) in effecting the solution and the resulting fee. Any other party performing any services

related to this engagement will have their own engagement letters with the client. Should KPMG's fee be less than otherwise because of another party performing certain aspects of the service to be rendered, any such fee reduction will be based on a reasonable approach.]

8) KPMG can not pay First Union a referral fee or commission. [] [KPMG will not pay First Union anything.]

9) KPMG can not share joint and several liability with First Union. [] [KPMG will not share any liability with First Union.]

10) There can be no dependency between KPMG and First Union in being able to deliver this service/strategy. []
[There will be no dependency between KPMG and First Union in being able to deliver/perform this solution.]

It is anticipated that on a go forward basis, this relationship between KPMG and First Union will be discussed with the audit committee under business relationships. << File: FUDELAP.DOC >> << File: DELAP2.DOC >>
<< File: RFP1.DOC >>

Outlook Header Information

Conversation Topic: First Union RFP
Subject: FW: First Union Customer Services
From: Leak, Councill
Sender Name: Leak, Councill
To: Manth, Larry E
Delivery Time: 11/30/2001 11:11:33 AM
Creation Time: 11/30/2001 11:11:32 AM
Modification Time: 11/30/2001 11:11:33 AM
Submit Time: 11/30/2001 11:11:33 AM
Importance: 111
Priority: 110
Sensitivity: 110
Flags: 113
Size: 115826

kpmg

To: SC2 Marketing Group

From: Andrew Atkin

Date: February 16, 2001

Re: Agenda from Feb 16th call and goals for next two weeks

- Community Trust
 - WNT given initial approval but uncertainty as to whether can use charitable contribution carry forward
 - The community trust alternative should not be thought of as a replacement strategy for the basic SC2
 - Remember also that the benefit (and hence our fee) is 40-50%
 - The TE group needs to be involved with every community trust we speak with.
 - **GOAL:** Each region should email me in the next two weeks 1 or 2 opportunities where the dollar amounts are large enough to justify this approach and where there is a strong likelihood the opportunity will close if we pitch the community trust. Please review OMS comments and "dead" deals to see if we can re-approach with this alternative
- Texas S corporation list
 - Gary Choate in Dallas has obtained from the state of TX a list of every S corp that filed a TX. Franchise tax return.
 - The list is not limited to TX companies; it includes every S corp that does business in TX.
 - No size information is included though.
 - I will distribute it on CD to one person in each region (19 megs size!)
 - **GOAL:** Please review your relevant region and pull out those companies you would like to call directly. Create a separate document with those opportunities in your region for which you would to have the calling center follow up and email it to me (except TX, which will be too large for email – Gary please send yours to calling center directly).
- Law Firm
 - John Schrier in N.Y. informed me that Bryan, Cave, a pre-eminent St. Louis, MO - based law firm has indicated its willingness to issue a confirming tax opinion for the SC2 transaction, as well as provide requisite legal services. Bryan, Cave employs close to 600 professionals, with additional offices in Kansas City, New York, Washington, D.C., Irvine, Santa Monica and Phoenix, among others. They also have indicated a willingness to bring us out to some of their midwestern clients. Their confirmation of the transaction will provide us with considerable leverage in the midwest marketplace.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations EXHIBIT #155 - FN 156
--

KPMG 0051135

REDACTED

- o **GOAL:** Midwest people, please contact John Schrier and discuss how we can use this relationship to generate new opportunities.
- **Car dealership referrals**
 - o Gary Choate explained that [REDACTED] has expressed an interest in referring us to [REDACTED] group if there is something in it for him. We will be having a follow up call with Gary, Mark Hutchison, Larry and appropriate DPP people to see what we can do to take advantage of this opportunity. Mark & Rich – decide whether it makes sense to approach [REDACTED] and ask for referrals.
- **Audit guidance.**
 - o In the next few weeks there will be guidance on how to handle financial statement issues published in the toolkit.
- **Regional goals for next two weeks**
 - o **Southwest:** Close [REDACTED] for \$500K each. Set up 3 other meetings.
 - o **South:** I have calendared 3/5-3/8 to come out there – set up at least two meetings for my visit. See if we can set up a meeting w/ National Distributing to discuss community trust.
 - o **Northeast:** I have calendared 3/1 and 3/2 to come out there – set up at least two meetings for my visit.
 - o **Midwest:** I have calendared 2/26 – 2/28 to come out there – set up at least two meetings for my visit.
 - o **Midatlantic:** We have to generate more leads. Larry Silver will follow up with appropriate people in Midatlantic to get the word out.
 - o **West:** 1) Pacific NW: [REDACTED] for \$320K (grandfathered deal). I have calendared 2/19 and 2/22 – 2/23 to come out there – set up at least two meetings for my visit; 2) Hawaii: [REDACTED] for \$500,000 and see if we can generate additional leads; 3) California: Close two deals in next two weeks (go Mark!); [REDACTED] – set up follow up meeting; [REDACTED] – bring to a close; MRL – Mark will work behind the scenes to get Mike's ear and posture us right for MRL's internal discussion with owner; 4) Salt Lake: need to determine whether nonresident shareholder issue makes Utah no good; if not get with Norm Lytle and set up meetings.

Message0012	
Subject:	Action Required: Channel Conflict for SC2
From:	POSTMASTER-US
Date:	8/14/2000 11:20:57 AM
CC:	Cockrell, Sandra J; Schmidt, Michael (US/NSS-MONTVALE)
Message Body	
<p>Date: August 14, 2000</p> <p>To: US Tax Partners</p> <p>From: Richard Rosenthal - New York</p> <p>cc: S. Cockrell - Ft. Wayne M. Schmidt - NSS/Montvale</p> <p>Subject: Action Required: Channel Conflict on SC2</p> <p>Attachment: 1 Microsoft Excel file - SC2leads.xls</p> <p>ALERT: SC2 Channel Conflict: YOU NEED TO REVIEW THE ATTACHED TARGET LIST</p> <p>We have successfully introduced the SC2 strategy (S-Corporation Charitable Contribution Strategy) to a number of companies, and we want to build on that momentum. SC2 is designed to enable shareholders of S-Corporations to make charitable contributions in a tax-efficient manner, without immediate outlay of cash, and thereby enhancing the S-Corporation's cash flow for business growth and expansion. An SC2 engagement generally includes the following: Benefit Analysis, Implementation and a Tax Opinion.</p> <p>The attached target list contains more than 300 S-Corporations with revenue between \$20-80 million (source: D&B, June 2000).</p> <p>We will be using the Practice Development Coordinators (telemarketers) to assist us with this effort. They will pre-qualify the targets, and set up phone appointments between the tax professional/BDM and the decision-maker. A first step in this process is to conduct a "channel conflict" to ensure that you have the opportunity to notify us regarding those companies with whom you have a relationship and you do NOT want to receive a call from our Practice Development Coordinators.</p> <p>You must forward the names of all companies that you do NOT want the practice development coordinators to call, to your Area Marketing Director (see the list below) by Monday, August 21. Either email the AMD the name of the company, or mark an "x" in the column titled "Do not call" in the attached spreadsheet, and forward it to the AMD.</p> <p>Please note that if you remove a company from the list, your Area Managing Partner will be following up with you three weeks after the call activity starts, to make sure that you have approached the client. If no activity has occurred we will ask the Practice Development Coordinators to schedule an appointment for one of our Tax professionals.</p> <p>Thank you.</p> <p>Tax Area Marketing Directors</p> <p>Mid-Atlantic Michelle Shearon Greensboro 703-747-5904 Midwest Cheryl Dillman Chicago 312-665-1306</p>	

Proprietary Material
Confidentiality Requested

KPMG 0049125

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 157

3582

Page 2 of 2

Northeast Kathy Hill New York 212-872-6763
Southeast Trish McGinty Atlanta 404-614-8662
Southwest Jonathan Pullano Dallas 214-840-4055
West Janine Rudow San Francisco 415-743-5411

Attachment

SC2leads.XLS

Outlook Header Information

Conversation Topic: pre-channel conflict -- please take action
Subject: Action Required: Channel Conflict for SC2
From: POSTMASTER-US
Sender Name: POSTMASTER-US
CC: Cockrell, Sandra J; Schmidt, Michael (US/NSS-MONTVALE)
Received By: Klein, Wendy (NSS-Tax)
Delivery Time: 8/14/2000 11:20:57 AM
Creation Time: 8/14/2000 11:17:44 AM
Modification Time: 8/14/2000 11:20:57 AM
Submit Time: 8/14/2000 11:20:07 AM
Importance: 8/1
Priority: 8/0
Sensitivity: 8/0
Flags: 8/16
Size: 8/305616

3583

Message0041	
Subject:	RE: S-Corps Carolinas
From:	Ronnie III, Leonard H
Date:	3/26/2001 11:46:42 AM
To:	Crew, Gary A
CC:	Leak, Council
Message Body	
<p>Gary,</p> <p>Attached is the list of NC and SC S-corps that you ordered. Please let me know if you have any questions.</p> <p>Len</p> <p>-----Original Message-----</p> <p>From: Crew, Gary A</p> <p>Sent: Thursday, March 01, 2001 10:17 AM</p> <p>To: Ronnie III, Leonard H</p> <p>Cc: Leak, Council</p> <p>Subject: RE: S-Corps Carolinas</p> <p>Leonard,</p> <p>I have discussed the list with Council Leak and we have decided on the "Enhanced Telemarketing" format. We would like to specify the sales volume information verses the employment count. We would like this information for North and South Carolina in disk format.. We will use this as a test to determine benefit before ordering for the SE.</p> <p>Let me know how long it may take. You may use the development number below for charges.</p> <p>Thanks in advance!</p> <p>Gary Crew</p> <p>-----Original Message-----</p> <p>From: Ronnie III, Leonard H</p> <p>Sent: Monday, February 26, 2001 12:46 PM</p> <p>To: Crew, Gary A</p> <p>Cc: McGinty, Patricia F</p> <p>Subject: RE: S-Corps Carolinas</p> <p>Gary,</p> <p>Attached is a price list for D&B. There are several options for the deliverable. Please let me know which one you would like and I will place the order.</p> <p>Len</p> <p><< File: Product Chart.xls >></p> <p>-----Original Message-----</p> <p>From: Crew, Gary A</p> <p>Sent: Friday, February 23, 2001 11:58 AM</p> <p>To: Ronnie III, Leonard H</p>	

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 157

KPMG 0050818

Subject: FW: S-Corps Carolinas

Leonard,

Please order the S-corp report for North and South Carolina. Use the development number 10333135 for charges (see note below)

Thanks in advance

Gary Crew

-----Original Message-----

From: Leak, Councill

Sent: Friday, February 23, 2001 11:53 AM

To: Crew, Gary A

Subject: RE: S-Corps Carolinas

Gary, I don't recall seeing the list before. Let's order and see what we get. Use my SC2 development number 10333135.

Councill

J. Councill Leak

Partner, Federal Tax Services/Stratecon Practice

KPMG LLP, Charlotte, NC

Direct: 704.371.8135

Fax: 704.335.5377

Cell: 704.906.4520

e-mail: cleak@KPMG.com

Our conclusions are limited to the conclusions specifically set forth herein and are based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

The information in this email is confidential and may be legally privileged. It is intended solely for the addressee. Access to this email by anyone else is unauthorized. If you are not the intended recipient, any disclosure, copying, distribution or any action taken or omitted to be taken in reliance on it, is prohibited and may be unlawful. When addressed to our clients any opinions or advice contained in this email are subject to the terms and conditions expressed in the governing KPMG client engagement letter

-----Original Message-----

From: Crew, Gary A

Sent: Friday, February 23, 2001 10:59 AM

To: Leak, Councill

Subject: FW: S-Corps Carolinas

Councill,

Proprietary Material
Confidentiality Requested

KPMG 0050819

Review the attached file. I will OK the order if it is what you are looking for. Have you seen this list before?

Gary

-----Original Message-----

From: Ronnie III, Leonard H
Sent: Friday, February 23, 2001 10:55 AM
To: Crew, Gary A; McGinty, Patricia F
Subject: RE: S-Corps Carolinas

Gary,

We will not know the cost of the list until it is run. It will probably be in the range of \$100-\$200, although I cannot guarantee this. It will include standard company information from Dun & Bradstreet. I have attached a sample similar to what we will receive.

Len

<< File: SC2 all.xls >>

-----Original Message-----

From: Crew, Gary A
Sent: Friday, February 23, 2001 10:50 AM
To: McGinty, Patricia F
Cc: Ronnie III, Leonard H
Subject: RE: S-Corps Carolinas

Tricia,

What is the cost? What info is included with the list? Do you want my expense code? I suggest we put it on Paul's budget.

Let me know and Thanks for your help!

Gary

-----Original Message-----

From: McGinty, Patricia F
Sent: Friday, February 23, 2001 10:48 AM
To: Crew, Gary A
Cc: Ronnie III, Leonard H
Subject: FW: S-Corps Carolinas

Please see Len's comments. We need a charge number to proceed. Thanks.

Tricia

-----Original Message-----

From: Ronnie III, Leonard H
Sent: Thursday, February 22, 2001 7:30 PM
To: McGinty, Patricia F
Subject: RE: S-Corps Carolinas

Tricia, **Proprietary Material**
 Confidentiality Requested

KPMG 0050820

The only way to get Scorps is to order a list from D&B. If you send me a charge number, I will order them for you.

3586

Len

-----Original Message-----

From: McGinty, Patricia F

Sent: Thursday, February 22, 2001 10:55 AM

To: Ronnie III, Leonard H

Cc: Crew, Gary A

Subject: S-Corps Carolinas

Len:

Could you get me a list of S-Corp's for the Carolina's? Thanks.

Tricia

Attachment

S Corps - NC & SC.xls

Outlook Header Information

Conversation Topic: S-Corps Carolinas

Subject: RE: S-Corps Carolinas

From: Ronnie III, Leonard H

Sender Name: Ronnie III, Leonard H

To: Crew, Gary A

CC: Leak, Council

Received By: Leak, Council

Delivery Time: 3/26/2001 11:46:42 AM

Creation Time: 3/26/2001 11:46:32 AM

Modification Time: 3/26/2001 11:46:42 AM

Submit Time: 3/26/2001 11:46:39 AM

Importance: 3/1

Priority: 3/0

Sensitivity: 3/0

Flags: 3/17

Size: 3/355467

Message0032	
Subject:	RE: SC2 target list
From:	Schrier, John V
Date:	4/23/2001 6:52:45 AM
To:	Crawford, Thomas W
Message Body	
<p>I think that would be a good idea for a first step, with the charge of eliminating companies from other lists and, then (subject to next sentence) determining qualification. While I do understand that cold calling to set up meetings will be a no-no, I am going to check into whether we can use the call center to determine qualification (S corporation status, number of shareholders, level of income). Perhaps using call center for screening, but not having them set up phone ICV's, would be okay. We could use the refined list in connection with identifying direct and indirect relationships.</p> <p>If Larry Delap has a problem with ANY use of the call center, then we will need to find a different way to identify relationships with these companies. I copied Barry Auerbach in the hope that some people within our real estate practice will have relationships or connections, etc.</p> <p>Thoughts?</p> <p>-----Original Message----- From: Crawford, Thomas W Sent: Monday, April 23, 2001 7:35 AM To: Schrier, John V Subject: RE: SC2 target list</p> <p>who is going to go into this list? can it be someone from marketing?</p> <p>-----Original Message----- From: Schrier, John V Sent: Sunday, April 22, 2001 10:29 PM To: Crawford, Thomas W Cc: Manth, Larry E; Atkin, Andrew S; Stile, Richard; Auerbach, Barry S Subject: RE: SC2 target list</p> <p style="text-align: right;">KPMG 0050029</p> <p>1. I do not know how to ascertain whether we have effectively exhausted all of our contacts. Activities to date have involved getting the word out, and fully mining the lists described in (2), below. 2. This is a new list, that was obtained only shortly before the new no-cold-call rule was adopted. We have not previously reviewed it. To date, the lists we've worked through to my knowledge have been the following (a) tax returns we handle, (b) a list devolved by our marketing department based upon certain criteria they selected, and (b) a list of NY S corporations that have filed Texas franchise tax returns. 3. I have not yet run a comparison between this and the other S corporation lists we've had, but on an eyeball basis I do not believe there are many material overlaps. 4. I think there are over 300 Tri-State real-estate related companies on the list; we have not yet determined precisely how many are S corporations and therefore haven't determined how many would make good candidates. 5. Although few if any of these companies likely are clients (we'll have to check), I am hopeful that we will find many instances in which people within our NE practice (in the Tri-State area in particular) will recognize a name/relationship they had not heretofore considered a potential candidate. It may also be possible to identify instances in which we do not directly have relationships with the owners of one or more particular company, but a professional has relationships with a person outside KPMG who does have relationships with many of these companies. I note in this connection that all of these companies are tied together in at least two respects: real-estate related services, and involvement with Israel Bonds. Where we have clients involved with real estate activities, it seems logical to expect that we have run across these companies in connection with their providing services to our clients.</p>	

-----Original Message-----

From: Crawford, Thomas W
 Sent: Sunday, April 22, 2001 8:35 PM
 To: Schrier, John V
 Cc: Manth, Larry E; Atkin, Andrew S; Stile, Richard; Auerbach, Barry S
 Subject: RE: SC2 target list

didn't we already go to (or call) all clients and companies we have contacts? Didn't we previously review this list and use it to call additional potential targets this fall? IS this a new list? or how many new cos are here?

-----Original Message-----

From: Schrier, John V
 Sent: Friday, April 20, 2001 5:36 PM
 To: Auerbach, Barry S; Crawford, Thomas W
 Cc: Manth, Larry E; Atkin, Andrew S; Stile, Richard
 Subject: RE: SC2 target list

REDACTED

Barry and Tom,

We've been able to pull together a list (attached) of what we expect represent a good number of S corporations that we think may have income and shareholder information making them good candidates for the SC2 solution. Tom, I think you've actually seen this list. The list is of real estate-related companies that participate in Israel Bonds activities, such as contractors, architects, suppliers and the like (including, for example, on which we've already called). We are trying to find a way to identify warm leads into these companies, perhaps through introductions provided by companies with which we already have good relationships or client relationships, since cold calls are no longer permitted for this structure.

I would appreciate your thoughts as to how best to tackle this opportunity.

Thanks,

John

<< File: 3595.XLS >>

-----Original Message-----

From: Atkin, Andrew S
 Sent: Friday, April 20, 2001 5:29 PM
 To: Schrier, John V; Stile, Richard
 Cc: Manth, Larry E
 Subject: RE: SC2 target list

John:

Sorry about that. I thought it was from Richard.

I still am not sure who to send it to though.

Andrew

Proprietary Material
 Confidentiality Requested

-----Original Message-----

From: Schrier, John V
 Sent: Friday, April 20, 2001 2:28 PM
 To: Atkin, Andrew S; Stile, Richard

KPMG 0050030

Cc: Manth, Larry E
 Subject: RE: SC2 target list

Not a bad idea, as it is my list. Note that very few are architects; all are in the real estate industry. The key is to try to identify relationships that our professionals may have with these firms, or relationship with people who have relationships with these companies.

-----Original Message-----

From: Atkin, Andrew S
 Sent: Friday, April 20, 2001 5:26 PM
 To: Stile, Richard
 Cc: Schrier, John V; Manth, Larry E
 Subject: SC2 target list

Richard:

Thanks for sending me the list of architects in the NE. Unfortunately, the firm has recently decided not to continue our cold calls for SC2 and to only use warm relationships to market the solution. I am not sure who to send the list to around the NE to see if anyone has relationships. I would suggest working with John Schrier on this issue.

Thanks

Andrew S. Atkin
 KPMG
 355 South Grand Avenue
 Suite 2000
 Los Angeles, CA 90071
 (213) 955-8830
 Fax (213) 630 2279
 aatkin@kpmg.com

Our advice in this email and any attached documents is limited to the conclusions specifically set forth herein and is based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. In rendering our advice, we are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

Outlook Header Information

Conversation Topic: SC2 target list
 Subject: RE: SC2 target list
 From: Schrier, John V
 Sender Name: Schrier, John V
 To: Crawford, Thomas W
 Delivery Time: 4/23/2001 6:52:45 AM
 Creation Time: 4/23/2001 6:52:40 AM
 Modification Time: 4/23/2001 6:54:11 AM
 Submit Time: 4/23/2001 6:54:10 AM
 Importance: 4/1
 Priority: 4/0

Proprietary Material
 Confidentiality Requested

KPMG 0050031

3590

Sensitivity: 4/0
Flags: 4/1
Size: 4/12975

Proprietary Material
Confidentiality Requested

KPMG 0050032

Message0007	
Subject:	SC2: Practice Development Coordinators Involvement
From:	Klein, Wendy (NSS-Tax)
Date:	6/27/2000 11:04:56 AM
To:	Springer, Mark A; Manth, Larry E
CC:	Cockrell, Sandra J; Moore, Colleen A
Message Body	
<p>Larry:</p> <p>I wanted to follow up on the discussion that Mark Springer and you had regarding SC2 last week. As you know the PDCs (telemarketers) are preparing to assist you with qualifying targets for this effort. We have purchased a list from D&B of S-Corporations that the PDCs will use for this effort.</p> <p>I wanted to review the protocol with you that we follow:</p> <p>NO CALLS WILL BE MADE PRIOR TO YOUR APPROVAL of the PDC Talk Points (attached) and the completion of the steps below:</p> <ul style="list-style-type: none"> - Larry Manth to review PDC talk points and sign off (Note our PDCs will never dispense any technical information regarding the solution. They will always recommend that the target speak directly with one of our SC2 deployment team for that information). - Larry Manth to conduct training for the PDCs (simple overview of the solution and ways to handle objections, questions, etc.) - Tax Marketing to develop target list with assistance from Larry Manth <ul style="list-style-type: none"> - identify target criteria so we can prioritize D&B and Area target list (currently we have close to 3000 targets) - Conduct channel conflict among all tax partners to insure that we have their permission to contact targets - Confirm calendars with all SC2 Deployment Champions for phone appointment scheduling availability - Identify the BDMs that will be involved in the SC2 PDC effort (they will be responsible for coordinating with the SC2 Area Deployment Champions) <ul style="list-style-type: none"> - note that based on feedback from the ASDs it appears that more than one BDM is involved per area. Is this appropriate? <p>Note that we will monitor the success of the calls and if we have positive results we will move to Phase II.</p> <p>Larry once you have had time to review this please let us know when you are available for a conference call. Today or tomorrow would be fine with our team. Thanks.</p> <p>Once we come to conclusions with regard to the action we are going to take, it is important for you to notify your team.</p>	
Attachment	
SC2ScriptMONT 06191.doc	

Proprietary Material
Confidentiality Document

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 160

KPMG 0049116

Outlook Header Information

Conversation Topic: SC2: Practice Development Coordinators Involvement
Subject: SC2: Practice Development Coordinators Involvement
From: Klein, Wendy (NSS-Tax)
Sender Name: Klein, Wendy (NSS-Tax)
To: Springer, Mark A; Manth, Larry E
CC: Cockrell, Sandra J; Moore, Colleen A
Delivery Time: 6/27/2000 11:04:56 AM
Creation Time: 6/27/2000 11:04:56 AM
Modification Time: 7/18/2000 9:22:19 AM
Submit Time: 6/27/2000 11:04:56 AM
Importance: 6/1
Priority: 6/0
Sensitivity: 6/0
Flags: 6/17
Size: 6/38470

Message0178	
Subject:	FW: SW SC2 Progress
From:	Duncan, Douglas P
Date:	11/15/2000 9:40:29 AM
To:	Terracina, Michael P; Choate, Gary M
CC:	Manth, Larry E
Message Body	
<p>Gary and Mike,</p> <p>Detailed message from Ken, but in summary: The number of targets here is pretty big, so I intend to help Ken trim it down a little, but who would you like to add to the deployment team? Maybe Mike Johnston, Powell in Colorado and myself. I think it is a bit early to worry about lack of resources, but I want him to understand that we are ready to pursue opportunities in this region. Also, I looked over the script below and feel it should fit our needs for this.</p> <p>Gary, I think that you mentioned you would talk with Jonathan Pullano regarding our efforts, but let me know if you want me involved with that.</p> <p>Thanks Doug</p> <p>-----Original Message----- From: Scheffler, Kenneth J Sent: Wednesday, November 15, 2000 8:23 AM To: Duncan, Douglas P Cc: Cockrell, Sandra J; Meek, Christine R; Cavaliere, Christine D; Schmidt, Michael (US/NSS-MONTVALE); Manth, Larry E; Smith, Barbara J Subject: SW SC2 Progress Importance: High</p> <p>Doug,</p> <p>As I mentioned the other day, the list you FAXed is ready for channel conflict. There are 39 targets on it.</p> <p>The Clickdata list is being researched right now against OMS to identify any TSPs, National Accounts or Subsidiaries of National Accounts. Because it is overwhelmingly auto/truck dealers, I don't expect this effort to turn up much, but it's step we have to go through. This list settled out at 670 targets. We expect that effort to be completed by the end of tomorrow.</p>	

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 160

KPMG 0048315

I've received your FedEx of the private companies in CO, San Antonio, Austin and the Metroplex. The Harris County list (Houston) seems to be all public companies, so we won't be using that. I'm preparing an electronic version of the others today and then it will also have to be cross-referenced against OMS before it goes out for channel conflict. It should have 125 targets on it.

We should send out all three lists as one channel conflict. We should be in a position to hand this off to Jonathan Pullano for him to send out the channel conflict either by the end of the day Friday or first thing Monday.

I need the following items from you:

- 1.) Please verify with Gary/Mike who the members of the deployment team will be for this SC2 effort. In other words, who are the partners/professionals for which we will be setting appointments? The last time we were calling for SC2 in the SW, we were setting appointments for the following people:

Mike Terracina
Carol Warley

Given the size of the target list (800+) we might need some additional resources on the deployment team side.

- 2.) If new people are brought onto the deployment team for this effort, I strongly suggest a conference call be held with them to bring them up to speed on the Solution, put them on notice of the size and scope of this telemarketing effort, and share with them the script we use so they will know how we qualify the appointments for them.

For your convenience, the script we use is enclosed below.

Once we have the make up of the deployment team, Barb Smith of my staff will contact them for their availabilities for appointments.

- 3.) My final suggestion is that you and Mike/Gary should have a conference call with Jonathan Pullano for the purpose of introducing the two of you, and letting Jonathan know about the size, scope and import of this telemarketing effort. It would also be an opportunity to bring Jonathan into the loop about the lists he'll be receiving from me in the next few days and that they need to go out for channel conflict pronto.

3595

If the TSPs are given the usual five business days to complete their review of the channel conflict, and Jonathan sends it out this coming Monday, that would allow for the results to come in here the middle of the following week. That would be ideal as I'll be out of the office Nov. 21-28.

If there's anything else, let me know.

Thanks,
Ken

Attachment

Sept19SC2Script.doc

Outlook Header Information

Conversation Topic: SW SC2 Progress
Subject: FW: SW SC2 Progress
From: Duncan, Douglas P.
Sender Name: Duncan, Douglas P.
To: Terracina, Michael P.; Choate, Gary M.
Cc: Martin, Larry H.
Received By: Terracina, Michael P.
Delivery Time: 11/15/2000 9:40:29 AM
Creation Time: 11/15/2000 9:28:52 AM
Modification Time: 11/15/2000 5:19:03 PM
Submit Time: 11/15/2000 9:40:29 AM
Importance: 102
Priority: 10
Sensitivity: 100
Flags: 101
Size: 114231

Sequential

From: Springer, Mark A [maspringer@KPMG.com]
 Sent: Thursday, January 03, 2002 3:39 PM
 To: Atkin, Andrew S; Manth, Larry E; DeLap, Larry
 Cc: Butler, Sheila M; Galbreath, Phillip L
 Subject: RE: SC2

IF the SC2 toolkit materials are needed to (1) complete implementation on engagements-in-process, or (2) continue limited marketing of the solution, then agree with Andrew that the folder should remain "active", albeit with VERY LIMITED access. I leave it to Larry D.

Mark Springer
 US Tax Innovation Center
 202-533-3076
 maspringer@KPMG.com

> -----Original Message-----
 > From: Atkin, Andrew S
 > Sent: Thursday, January 03, 2002 2:13 PM
 > To: Manth, Larry E; Springer, Mark A; DeLap, Larry
 > Cc: Butler, Sheila M; Galbreath, Phillip L
 > Subject: RE: SC2

> Larry:

> I would prefer to keep the folder up because this way I always know that
 > everyone on the implementation team is using the latest set of documents.
 > Things get confusing when everybody is trying to maintain the files on
 > their local computer.

> Thanks

> Andrew

> -----Original Message-----
 > From: Manth, Larry E
 > Sent: Thursday, January 03, 2002 9:04 AM
 > To: Springer, Mark A; DeLap, Larry
 > Cc: Atkin, Andrew S; Butler, Sheila M; Galbreath, Phillip L
 > Subject: RE: SC2

> Larry, sorry for the confusion, but Mark put it correctly. We shut down
 > the folder to all except a few individuals since we need the access for
 > documents and other items located in the folder to implement the
 > transaction.

> We don't need to keep the folder open any longer. But give us time to
 > copy any pertinent information (client files, contact info, certain
 > documents, etc.).

> Andrew, if you think otherwise, please respond.

> Thanks,

> Larry

> -----Original Message-----
 > From: Springer, Mark A
 > Sent: Thursday, January 03, 2002 8:49 AM
 > To: DeLap, Larry
 > Cc: Manth, Larry E; Atkin, Andrew S; Butler, Sheila M; Galbreath,

Proprietary Material
 Confidentiality Requested

1

KPMG 0013308

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 163

3597

> Phillip L
> Subject: FW: SC2
>
>
> Larry -- We did not literally "shut down" the Outlook folder, as it was
> (and still is) my/our understanding that SC2 was/is still being
> marketed...we simply limited access to you, Larry M., Andrew Atkin, and a
> few other members of their group in LA (at Larry's/Andrew's request). Are
> we now to literally shut down the outlook folder (we would still "save"
> the documents here in WNT) and remove SC2 from the active solution
> portfolio?
>
> Mark Springer
> US Tax Innovation Center
> 202-533-3076
> maspringer@KPMG.com
>
> -----Original Message-----
> From: Butler, Sheila M
> Sent: Thursday, January 03, 2002 5:24 AM
> To: Springer, Mark A
> Subject: FW: SC2
>
> FYI
>
>
> Sheila Butler
> kpmg Washington National Tax - Tax Innovation Center
>
> * (202) 533-3880
> * (202) 533-8545
> * sbutler@kpmg.com
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 7:00 PM
> To: Larry E Manth (E-mail); Atkin, Andrew S
> Cc: Sheila Butler (E-mail)
> Subject: FW: SC2
>
> For your action.
>
> -----Original Message-----
> From: Nance, Shelly
> Sent: Wednesday, January 02, 2002 11:12 AM
> To: DeLap, Larry
> Subject: RE: SC2
>
> SC2 is still in the Outlook folder under USWNT S-Corporation Charitable
> Contribution Strategy(SC2). I send out a monthly report for SC2 that
> shows all activity for a designated list of individuals assigned by the
> Deployment Champion created in Outlook by Sheila M. Butler. In order for
> this distribution list to be removed you need to contact Sheila Butler. I
> have no control over this. (she is in Outlook)
> SC2 is still listed as an active solution. Going forward...this is a
> solution in which I generate reports on a bi-weekly basis for Ralph
> Montejo and Patrick Brooks.
> I personally have no involvement with this activity, I only generate the
> activity report from OMS.
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 1:53 PM
> To: Nance, Shelly
> Cc: Larry E Manth (E-mail)

Proprietary Material
Confidentiality Requested

2

KPMG 0013309

3598

> Subject: FW: SC2
>
> Please advise what gave rise to your December 20 message and please
> discontinue any further activity with respect to SC2.
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, January 02, 2002 10:22 AM
> To: DeLap, Larry
> Subject: RE: SC2
>
> Larry, Fort Wayne hasn't done anything for quite a while (its been at
> least 1 year+). I'm not sure why they issue these reports, perhaps
> because SC2 is still on the active solution list. We have limited the
> marketing of SC2 significantly since our agreement 9 months ago. I
> removed myself as National leader and have not pitched SC2 since. We
> mandated strict compliance regarding the marketing of SC2 to all the areas
> -- no cold calls, only warm relationships, and minimum fee of \$500k. We
> also shut down the Outlook folder and discontinued bi-weekly calls.
>
> Thanks,
>
> Larry
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 9:54 AM
> To: Manth, Larry E
> Subject: RE: SC2
>
> Shelly Nance is in Fort Wayne, which is "cold call central". How can she
> (or he) be involved in sending out messages about SC2 if it is not being
> mass marketed.
>
> You did agree nine months ago to winding down the marketing of SC2.
>
> << Message: RE: SC2 - Client Base Expansion >>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Sunday, December 30, 2001 12:46 PM
> To: DeLap, Larry
> Cc: Brockway, David H; Kelliher, William B; Smith, Richard H (US/WEST
> AMP); Rosenthal, Richard P; Atkin, Andrew S; Elgin, Evelyn; Duer, Walter
> M; Affonso, Dale A
> Subject: RE: SC2
>
> Larry, I think there is some misunderstanding over the OMS report and our
> marketing. First of all, after our conference call with Rick, we shut
> down the Outlook folder. We also mandated that there are to be no more
> cold calls for SC2, as well raising the minimum fee to \$500,000 from
> \$250k. The OMS report is grossly misleading with respect to our marketing
> of SC2. My estimate is that less than 100 S-corporations know about the
> general strategy. Our marketing of the strategy has been extremely
> tight-lipped. More than 90% of the companies on the OMS report never
> heard about SC2 for various reasons -- too many shareholders, not enough
> income, not an S-corp, etc... I agree that we need to put a sunset on this
> strategy, but let's come to some agreement and parameters.
>
> Thanks,
>
> Larry
>
>
> Proprietary Material
Confidentiality Requested

3599

> -----Original Message-----
> From: DeLap, Larry
> Sent: Saturday, December 29, 2001 4:55 PM
> To: Larry E Manth (E-mail)
> Cc: David Brockway (E-mail); Kelliher, William B; Richard Smith
> (E-mail); Richard Rosenthal (E-mail); Atkin, Andrew S; Evelyn Elgin
> (E-mail)
> Subject: FW: SC2
>
> Larry -
>
> We had a verbal agreement following a conference call with Rick Rosenthal
> earlier this year that SC2 would not be mass marketed.
>
> In any case, the time has come to formally cease all marketing of SC2.
> Please so notify your deployment team and the marketing directors.
>
> Larry
>
> -----Original Message-----
> From: Brockway, David H
> Sent: Friday, December 21, 2001 2:57 PM
> To: Kelliher, William B
> Cc: DeLap, Larry; Smith, Richard H (US/WEST AMP)
> Subject: RE: SC2
>
>
> It looks like they have already tried over 2/3rds of possible candidates
> already, if I am reading the spread sheet correctly. Could you set up a
> conference call at a convenient time after the holidays for you, Larry,
> Richard and I, so we can all review the bidding. I have a feeling the
> horse is already out of the barn, but let's discuss the situation and see
> if there anything that should be done at this point. Thanks.
>
> -----Original Message-----
> From: Kelliher, William B
> Sent: Thursday, December 20, 2001 3:30 PM
> To: Brockway, David H
> Subject: FW: SC2
>
>
> Dave:
>
> I was copied on the message below, which appears to indicate that the firm
> is intent on marketing the SC2 strategy to virtually every S corp with a
> pulse (if S corps had pulses). Going way back to Feb. 2000, when SC2
> first reared its head, my recollection is that SC2 was intended to be
> limited to a relatively small number of large S corps. That plan made
> sense because, in my opinion, there was (and is) a strong risk of a
> successful IRS attack on SC2 if the IRS gets wind of it. Somewhere along
> the line, that marketing plan seems to have changed. According to the
> list attached to the message below, the intimate group of S corps
> potentially targeted for SC2 marketing has now expanded to 3,184
> corporations. Call me paranoid, but I think that such a widespread
> marketing campaign is likely to bring KPMG and SC2 unwelcome attention
> from the IRS. If so, I suspect a vigorous (and at least partially
> successful) challenge would result. I realize that the fees are
> attractive, but does the firm's tax leadership really think that this is
> an appropriate strategy to mass market?
>
> Bill
>
> -----Original Message-----
> From: Nance, Shelly
> Sent: Thursday, December 20, 2001 9:12 AM
> To: US-WNT S-Corporation Charitable Contribution Strategy
> Subject: SC2

Proprietary Material
Confidentiality Requested

4

KPMG 0013311

3600

> I have attached the Monthly OMS Activity Report for "SC2", and in addition
> the report will be posted to the "SC2" Outlook Deployment folder. We hope
> that the attached file will provide you with the necessary tools to
> further the success and measure the performance of your solution and will
> serve as the center of your discussion on your bi-weekly solution
> deployment team calls.
>
> The file contains a summary report of market activity from OMS for your
> solution. Please, review it and provide any new information to your Area
> Marketing Directors (Names Below) so that they can include it in OMS. In
> particular, look for all opportunities that have not shown any progress
> since last month (Selling Cycle Date clearly marked) and determine why the
> deal has stalled and what help you need to move it forward.
>
> The file is sorted by area, selling cycle step and then alpha by target
> that you can easily pull out your specific area.
>
> Tax Marketing Directors:
>
> Mid-Atlantic Marsha Shelton Tysons Corners 703-747-6946
> Midwest Christine Elliot Chicago
> 312-665-2709
> Northeast Rita Bacas New York
> 212-872-7909
> Southeast Trish McGinty Atlanta
> 404-614-8662
> Southwest Jonathan Pullano Dallas
> 214-840-4055
> West Melissa Fiorina San Francisco
> 415-951-7123
>
> Thank You!
>
> << File: SC2 12-19.XLS >>
>
> Shelly Nance
> National Assistant OMS Administrator
> 219-423-6818
> kpmg
>
>

Proprietary Material
Confidentiality Requested

KPMG 0013312

Sequential

From: Atkin, Andrew S [a.atkin@KPMG.com]
 Sent: Thursday, January 03, 2002 2:13 PM
 To: Manth, Larry E; Springer, Mark A; DeLap, Larry
 Cc: Butler, Sheila M; Galbreath, Phillip L
 Subject: RE: SC2

Larry:

I would prefer to keep the folder up because this way I always know that everyone on the implementation team is using the latest set of documents. Things get confusing when everybody is trying to maintain the files on their local computer.

Thanks

Andrew

> -----Original Message-----
 > From: Manth, Larry E
 > Sent: Thursday, January 03, 2002 9:04 AM
 > To: Springer, Mark A; DeLap, Larry
 > Cc: Atkin, Andrew S; Butler, Sheila M; Galbreath, Phillip L
 > Subject: RE: SC2
 >
 > Larry, sorry for the confusion, but Mark put it correctly. We shut down
 > the folder to all except a few individuals since we need the access for
 > documents and other items located in the folder to implement the
 > transaction.
 >
 > We don't need to keep the folder open any longer. But give us time to
 > copy any pertinent information (client files, contact info, certain
 > documents, etc.).
 >
 > Andrew, if you think otherwise, please respond.
 >
 > Thanks,
 >
 > Larry
 >
 > -----Original Message-----
 > From: Springer, Mark A
 > Sent: Thursday, January 03, 2002 8:49 AM
 > To: DeLap, Larry
 > Cc: Manth, Larry E; Atkin, Andrew S; Butler, Sheila M; Galbreath,
 > Phillip L
 > Subject: FW: SC2
 >
 >
 > Larry -- We did not literally "shut down" the Outlook folder, as it was
 > (and still is) my/our understanding that SC2 was/is still being
 > marketed...we simply limited access to you, Larry M., Andrew Atkin, and a
 > few other members of their group in LA (at Larry's/Andrew's request). Are
 > we now to literally shut down the outlook folder (we would still "save"
 > the documents here in WNT) and remove SC2 from the active solution
 > portfolio?
 >
 > Mark Springer
 > US Tax Innovation Center
 > 202-533-3076
 > maspringer@KPMG.com
 >
 > -----Original Message-----

Proprietary Material
 Confidentiality Requested

3602

> From: Butler, Sheila M
> Sent: Thursday, January 03, 2002 5:24 AM
> To: Springer, Mark A
> Subject: FW: SC2
>
> FYI
>
>
> Sheila Butler
> kpmg Washington National Tax - Tax Innovation Center
>
> * (202) 533-3880
> * (202) 533-8545
> * sbutler@kpmg.com
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 7:00 PM
> To: Larry E Manth (E-mail); Atkin, Andrew S
> Cc: Sheila Butler (E-mail)
> Subject: FW: SC2
>
> For your action.
>
> -----Original Message-----
> From: Nance, Shelly
> Sent: Wednesday, January 02, 2002 11:12 AM
> To: DeLap, Larry
> Subject: RE: SC2
>
> SC2 is still in the Outlook folder under USWNT S-Corporation Charitable
> Contribution Strategy(SC2). I send out a monthly report for SC2 that
> shows all activity for a designated list of individuals assigned by the
> Deployment Champion created in Outlook by Sheila M. Butler. In order for
> this distribution list to be removed you need to contact Sheila Butler. I
> have no control over this. (she is in Outlook)
> SC2 is still listed as an active solution. Going forward...this is a
> solution in which I generate reports on a bi-weekly basis for Ralph
> Montejo and Patrick Brooks.
> I personally have no involvement with this activity, I only generate the
> activity report from OMS.
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 1:53 PM
> To: Nance, Shelly
> Cc: Larry E Manth (E-mail)
> Subject: FW: SC2
>
> Please advise what gave rise to your December 20 message and please
> discontinue any further activity with respect to SC2.
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Wednesday, January 02, 2002 10:22 AM
> To: DeLap, Larry
> Subject: RE: SC2
>
> Larry, Fort Wayne hasn't done anything for quite a while (its been at
> least 1 year+). I'm not sure why they issue these reports, perhaps
> because SC2 is still on the active solution list. We have limited the
> marketing of SC2 significantly since our agreement 9 months ago. I
> removed myself as National leader and have not pitched SC2 since. We
> mandated strict compliance regarding the marketing of SC2 to all the areas
> -- no cold calls, only warm relationships, and minimum fee of \$500k. We

Proprietary Material
Confidentiality Requested

2

KPMG 0013314

3603

> also shut down the Outlook folder and discontinued bi-weekly calls.
>
> Thanks,
>
> Larry
>
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Wednesday, January 02, 2002 9:54 AM
> To: Manth, Larry E
> Subject: RE: SC2
>
> Shelly Nance is in Fort Wayne, which is "cold call central". How can she
> (or he) be involved in sending out messages about SC2 if it is not being
> mass marketed.
>
> You did agree nine months ago to winding down the marketing of SC2.
>
> << Message: RE: SC2 - Client Base Expansion >>
>
>
> -----Original Message-----
> From: Manth, Larry E
> Sent: Sunday, December 30, 2001 12:46 PM
> To: DeLap, Larry
> Cc: Brockway, David H; Kelliher, William B; Smith, Richard H (US/WEST
> AMP); Rosenthal, Richard P; Atkin, Andrew S; Elgin, Evelyn; Duer, Walter
> M; Affonso, Dale A
> Subject: RE: SC2
>
> Larry, I think there is some misunderstanding over the OMS report and our
> marketing. First of all, after our conference call with Rick, we shut
> down the Outlook folder. We also mandated that there are to be no more
> cold calls for SC2, as well raising the minimum fee to \$500,000 from
> \$250k. The OMS report is grossly misleading with respect to our marketing
> of SC2. My estimate is that less than 100 S-corporations know about the
> general strategy. Our marketing of the strategy has been extremely
> tight-lipped. More than 90% of the companies on the OMS report never
> heard about SC2 for various reasons -- too many shareholders, not enough
> income, not an S-corp, etc... I agree that we need to put a sunset on this
> strategy, but let's come to some agreement and parameters.
>
> Thanks,
>
> Larry
>
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Saturday, December 29, 2001 4:55 PM
> To: Larry E Manth (E-mail)
> Cc: David Brockway (E-mail); Kelliher, William B; Richard Smith
> (E-mail); Richard Rosenthal (E-mail); Atkin, Andrew S; Evelyn Elgin
> (E-mail)
> Subject: FW: SC2
>
> Larry -
>
> We had a verbal agreement following a conference call with Rick Rosenthal
> earlier this year that SC2 would not be mass marketed.
>
> In any case, the time has come to formally cease all marketing of SC2.
> Please so notify your deployment team and the marketing directors.
>
> Larry

Proprietary Material
Confidentiality Requested

3

KPMG 0013315

3604

>
> -----Original Message-----
> From: Brockway, David H
> Sent: Friday, December 21, 2001 2:57 PM
> To: Kelliher, William B
> Cc: Delap, Larry; Smith, Richard H (US/WEST AMP)
> Subject: RE: SC2
>
> It looks like they have already tried over 2/3rds of possible candidates
> already, if I am reading the spread sheet correctly. Could you set up a
> conference call at a convenient time after the holidays for you, Larry,
> Richard and I, so we can all review the bidding. I have a feeling the
> horse is already out of the barn, but let's discuss the situation and see
> if there anything that should be done at this point. Thanks.
>
> -----Original Message-----
> From: Kelliher, William B
> Sent: Thursday, December 20, 2001 3:30 PM
> To: Brockway, David H
> Subject: FW: SC2
>
> Dave:
>
> I was copied on the message below, which appears to indicate that the firm
> is intent on marketing the SC2 strategy to virtually every S corp with a
> pulse (if S corps had pulses). Going way back to Feb. 2000, when SC2
> first reared its head, my recollection is that SC2 was intended to be
> limited to a relatively small number of large S corps. That plan made
> sense because, in my opinion, there was (and is) a strong risk of a
> successful IRS attack on SC2 if the IRS gets wind of it. Somewhere along
> the line, that marketing plan seems to have changed. According to the
> list attached to the message below, the intimate group of S corps
> potentially targeted for SC2 marketing has now expanded to 3,184
> corporations. Call me paranoid, but I think that such a widespread
> marketing campaign is likely to bring KPMG and SC2 unwelcome attention
> from the IRS. If so, I suspect a vigorous (and at least partially
> successful) challenge would result. I realize that the fees are
> attractive, but does the firm's tax leadership really think that this is
> an appropriate strategy to mass market?
>
> Bill
>
> -----Original Message-----
> From: Nance, Shelly
> Sent: Thursday, December 20, 2001 9:12 AM
> To: US-WNT S-Corporation Charitable Contribution Strategy
> Subject: SC2
>
> I have attached the Monthly OMS Activity Report for "SC2", and in addition
> the report will be posted to the "SC2" Outlook Deployment folder. We hope
> that the attached file will provide you with the necessary tools to
> further the success and measure the performance of your solution and will
> serve as the center of your discussion on your bi-weekly solution
> deployment team calls.
>
> The file contains a summary report of market activity from OMS for your
> solution. Please, review it and provide any new information to your Area
> Marketing Directors (Names Below) so that they can include it in OMS. In
> particular, look for all opportunities that have not shown any progress
> since last month (Selling Cycle Date clearly marked) and determine why the
> deal has stalled and what help you need to move it forward.
>
> The file is sorted by area, selling cycle step and then alpha by target
> that you can easily pull out your specific area.
>

Proprietary Material
Confidentiality Requested

4

KPMG 0013316

3605

> Tax Marketing Directors:
>
> Mid-Atlantic Marsha Shelton Tysons Corners 703-747-6946
> Midwest Christine Elliot Chicago
> 312-665-2709
> Northeast Rita Bacas New York
> 212-872-7909
> Southeast Trish McGinty Atlanta
> 404-614-8662
> Southwest Jonathan Pullano Dallas
> 214-840-4055
> West Melissa Fiorina San Francisco
> 415-951-7123
>
> Thank You!
>
> << File: SC2 12-19.XLS >>
>
> Shelly Nance
> National Assistant OMS Administrator
> 219-423-6818
> kpmg
>
>



Robert B. Coplan
07/19/2000 09:30 AM

To: Dickensg@aol.com@Internet
cc: Brian L. Vaughn/National/TAX/EYLLPAUS@EY-NAmerica
Subject: Re: [REDACTED] family-potential CDS deal

I think I have to stand on my prior response -- i.e., we cannot "promise" to return the fee if certain events occur that would make the tax results less obtainable. As you know, we go to great lengths to line up a law firm to issue an opinion pursuant to a separate engagement letter from the client that is meant to make the law firm independent from us. We do not want to convey the notion that our completing the transaction with the client is dependent on the issuance of a favorable opinion from the independent law firm. If the independent nature of the opinion were ever to be challenged, I think it would be a bad fact if there were a written indication that E&Y would return our fee if the supposedly independently engaged law firm were -- due to some post-transaction occurrence -- unable to issue the client an opinion. If all they want is a verbal assurance from us, I think I am still reluctant to do that, other than to reiterate the dispute resolution procedure that indicates our intention to review the transaction if the client does not receive the value they paid for. For a small transaction, I do not want to have to make a concession in this regard that we have not had to make for any other transaction, including some huge ones.
Dickensg@aol.com on 07/18/2000 10:18:14 PM



Dickensg@aol.com on 07/18/2000 10:18:14 PM

To: Robert B. Coplan/National/TAX/EYLLPAUS@EY-NAmerica
cc:
Subject: Re: [REDACTED] family-potential CDS deal

Thanks for the input. I think you misunderstood about the fee return. I think all the [REDACTED] want is a promise to return the fee if there was a development that would prevent them from receiving LLS's opinion and/or prevent EY from signing the tax return. They weren't asking for a money back guarantee. In the BOSS case PWC decided they could not issue the opinion after the notice came back and they returned their fee.

Note: The information contained in this message may be privileged and confidential and protected from disclosure. If the reader of this message is not the intended recipient, or an employee or agent responsible for delivering this message to the intended recipient, you are hereby notified that any dissemination, distribution or copying of this communication is strictly prohibited. If you have received this communication in error, please notify us immediately by replying to the message and deleting it from your computer. Thank you. Ernst & Young LLP

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 168

2003EY011939

Tax Innovation Center Solution and Idea Development - Year-End Results

May 30, 2001

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 179

XX-001490

FY01 Tax Solution/Service Idea Development/Deployment Achievements

- ◆ 39 solutions launched via Weekly Tax Solutions Conference Call or similar public forum (distance learning; service line meeting/call)
- ◆ FY01 revenue from Solutions as reported in OMS \$70 million; FY01 revenue from all Solutions \$340 million
- ◆ 140 new Tax Service Ideas/strategies deposited to Tax Service Idea Bank
- ◆ Significant WNT involvement in Tax labs/Solution Idea generation
- ◆ Significant WNT involvement in Solution/Service Idea Deployment

3608

XX-001491

Goal: Develop 6 Cross-functional (tax with assurance / consulting) Solutions

Cross-functional solutions launched:

- ◆ Intellectual Property Services
- ◆ Digital Marketplace Tax Suite
- ◆ Customer Relationship Management
- ◆ Economic Downturn Tax Consulting Services

3609

XX-001492

Goal: Deposit 150 New Ideas in Tax Service Idea Bank

Functional Group	Deposits	Expected Deposits	In the Pipeline
◆ SALT	32	7	18
◆ CAB	19	5	11
◆ Passthrough	14	2	9
◆ IES	13	11	27
◆ TCS	5	1	2
◆ Straecon	2	0	5
◆ ICS	22*	2	6
◆ Methods	4	2	68
◆ Insurance	3	4	7
◆ PFP	3	3	18
◆ Trade & Customs	4	0	0
◆ e-Tax	1	1	0
Total	122	38	171

XX-001493

* Includes 21 Lifecycle conversions posted

Goal: Improve Speed to Market

- ◆ Developed and implemented a new tracking and reporting system for technical, DPP, and TCS review of solutions and ideas
- ◆ Instituted Beta Test Opportunity Alerts

3611

5

XX-001494

Goal: Align Solution Ideas with Client Business and Industry Issues

Industry labs

- Industry lab structure developed and communicated to TILs and Tax Services Committee
- Labs held: Communications, Consumer Markets, Energy, Banking & Finance, e-Tax, Chemicals & Pharmaceutical, Software & Electronics, Industrial & Automotive Products

3612

XX-001495

Goal: Award 75 Light Bulbs and
\$50,000 to Non-WNT Idea Submitters

- ◆ Approximately 50 light bulbs and \$35K in cash will be awarded by 6/30/01

3613

XX-001496

Goal: e-Enable All Tax Solutions

- ◆ Revise development process to ensure we consider possible e-enhancements to all tax solutions
- ◆ Review all active tax solutions for opportunities to e-enable
 - TIC is working with Tax Technology and Office of Tax Digital Transformation to address these goals

3614

XX-001497

Goal: Provide Guidance to Solution Deployment Teams

- ◆ Promote use of Deployment Champion Manual
 - Completed and posted National and Area Deployment Champion Manual to TIC and Marketing home pages
 - Implemented an orientation process for deployment champions

3615

XX-001498

Goal: Provide Guidance to Solution Deployment Teams

- ◆ Working with tax leadership to revise the tax solution deployment process. Plan is to more actively involve tax leadership and TIC in the pre- and post-launch phase
 - Solution pre-launch conference calls
 - Solution revisit pre-calls
 - Document action items and facilitate follow-up
- ◆ Set deployment team revenue goals for all solutions
 - Revenue goals set and monitored as part of revisit process

3616

XX-001499

Goal: Improve Communication of Solutions and Ideas

- ◆ All new solutions discussed on weekly Solution conference call
- ◆ Tax Solution Alerts issued for all new solutions and all solutions featured on distance learning, with rare exceptions
- ◆ TSI Alerts issued for all TSIs
- ◆ All solutions and Tax Service Ideas incorporated into KMatch
- ◆ Providing an external version of KMatch to kpmgtax.com
- ◆ Canadian solutions added to KMatch
- ◆ UK solutions will be added to KMatch
- ◆ Assurance solutions may be added to KMatch

3617

XX-001500

Goal: Increase Revenue from Tax Service Idea Bank

- ◆ Assess effectiveness and promote use of TSIB and KMatch
 - TIC conducted focus groups in each area
- ◆ Develop system for obtaining and disseminating information on deployment of TSIB
 - ESP & TIC implementing ongoing TSIB promotion program (METSA, ITS, ES News)

3618

XX-001501

Goal: Measure Solution Profitability

- ◆ Captured solution development costs and revenue in PEAT and OMS
- ◆ Prepared quarterly Solution Profitability reports

3619

XX-001502

3620

From: POSTMASTER-US
Sent: Wednesday, December 12, 2001 2:02 PM
Cc: Smith, Richard H (US/WEST AMP)
Subject: FY02 Tax Strategy Meeting
DATE: December 12, 2001
TO: Tax Personnel - LA & PSW
FROM: Dale A. Affonso - Los Angeles
CC: Richard H. Smith - Mountain View
SUBJECT: FY02 Tax Strategy Meeting

Thank you for attending the FY02 Tax Strategy Meeting. It's now time to take action. As you enter the marketplace armed with the knowledge of "Taking Market Leadership," please remember to share your thoughts and experiences with us so we can better leverage the three key market pillars - Market Share, Client Centricity, and Market-Driven Solutions.

Using the three pillars as background, we want to hear more about:

- Teaming with Assurance;
- Ways to improve client relationships;
- How clients are responding to our services and solutions;
- Ideas for new services and solutions; and
- Best practices.

Achieving Market Leadership will require the entire team to share their experiences and work as a cohesive unit. Don't hesitate to contact me with questions and opportunities.

Best regards,

Dale A. Affonso
Partner in Charge of Tax Services
Los Angeles & Pacific Southwest
KPMG LLP
355 South Grand Avenue, Suite 2000
Los Angeles, CA 90071
Phone: (213) 955-8790
Fax: (213) 630-8036
E-mail daffonso@kpmg.com

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 183

XX-001733

		Various strategies that can be used to reduce the global, inter or prospective	These strategies are comprised of the legendary "4E's": Equity, Efficiency, Economics, and Expertise. (H&O, and Global Currency)	Generally available for all types of entities (including tax-exempt). Minimum gain is \$500,000. For corporations, the gain could have been recognized as far back as 1990 (capital loss carrybacks are available)	Source: Black (JA)-713-855-8020, David DeCicco (OO)-714-445-7951, David Greenberg (OO)-714-445-7951, David Greenberg (SF)-415-691-7511
1. Gain Mitigation		Various strategies designed to reduce taxable income of companies in foreign jurisdictions, reduce US tax liability, and reduce US tax using income shifting techniques	These strategies are primarily transactional driven, and some involve restructuring	Generally available for US companies with foreign operating or certain foreign companies operating in certain foreign jurisdictions	Mostly boutiques (Cheney) Forward, Overvalued (BOO),
2. Interstitial		Various strategies that can generate refunds for companies (and individuals) on a case-by-case basis. These strategies are as far back as WWII. These strategies also include a provision to help individuals with a pending NOLA lawsuit by transferring the benefit to a third party.	Financially distressed, cash flow motivated, or debt motivated. Individuals have the ability to monetize current net operating losses and/or operating losses and/or claims, selling the company, or transferring certain assets	For the refund strategies, any company that has previously paid Federal or State income taxes at least \$100,000 is eligible for a refund of such taxes (also applies to loss companies that have acquired profitable companies and are looking to monetize NOLA lawsuit. Ideal target has NOLA > \$20 million	None to many, depending on the particular strategy.
3. Net Operating Loss Monetization		Various strategies creating or utilizing an insurance company that can mitigate losses, and minimize capital losses, accelerate deductions, and minimize taxes	These strategies are comprised of franchise, 501(c)(15), WTS, caplives, etc.	Many...see particular	None to many, depending on the particular strategy
4. Risk Finance		Various strategies that can mitigate ordinary income and capital gains of S-corporations	These strategies are comprised of S-CZ, S-CZ variations, basis stuffing, and a variety of other types of entity-C	S-corporations with ordinary income > \$2 million or potential capital gains > \$5 million	Generally a minimum fee of \$250,000.
5. S-corporation Strategies		These strategies consist of many of the same strategies that can mitigate income structures, many of which are managed with investment techniques designed to accelerate deductions or income	These strategies are comprised of S-CZ, S-CZ variations, basis stuffing, and a variety of other types of entity-C	Many...see particular	None to many, depending on the particular strategy
6. Structured Finance and Structured Lending		Various strategies and techniques designed to accelerate deductions or income	These strategies are comprised of S-CZ, S-CZ variations, basis stuffing, and a variety of other types of entity-C	Many...see particular	None to many, depending on the particular strategy
7. Tax Accounting		Various strategies and techniques designed to accelerate deductions or income	These strategies are comprised of S-CZ, S-CZ variations, basis stuffing, and a variety of other types of entity-C	Many...see particular	None to many, depending on the particular strategy

3622

Redacted by the
Permanent Subcommittee
on Investigations

XX-001010-1025

Meeting Minutes – Monetization Solutions Task Force Teleconference

2:15 pm to 3:30 pm EST – November 30, 2000

Teleconference discussion attendees were T. Speiss, D. Baumann and R. Bickham.

The next teleconference is 10:30 am EST on 12/7/2000.

The purpose of the teleconference was to continue a discussion of the development of a revised business model for the Innovative Strategies (IS) Practice, based upon preliminary dialogue in an IS Lab meeting held on November 17, 2000. On that date a Task Force was formed with the above persons with T. Speiss as Task Force Leader.

A summary of the discussion follows

Discussion Agenda

1. General Overview of the KPMG U.S. Personal Financial Planning Practice(PFP);
2. Current Business Model of The Innovative Strategies (IS) Practice
3. Factors Causing a Change in The Current IS Business Model
4. Preliminary Steps in Implementing The New IS Business Model – 30 Days
5. Additional Tools, Human Resources and Additional Deployment Assets Needed to Implement The New IS Business Model

Proprietary Material
Confidentiality Requested

KPMG 0050624

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 192

1. General Overview of the KPMG U.S. Personal Financial Planning Practice (PFP)

The IS practice is a component of KPMG's U.S. PFP practice. The PFP practice's services are targeted at the high wealth individual marketplace, in addition to large employer groups, Fortune 500 entities and shareholders of large privately held entities. PFP clients include the affluent, e-commerce entrepreneurs, C-Class executives, corporate founders, professional athletes, entertainers, professional sports teams, and employees of successful new economy/old economy entities. PFP relationships have been valuable in helping to drive additional revenue opportunities for KPMG.

The PFP practice's primary lines of service in the United States are Innovative Strategies, Corporate Programs, Investment Advisory and Core Tax. Additional PFP service lines include Family Wealth and other specialty services. There is a focus on PFP professionals to practice within specific services lines to drive KPMG revenue, as can be seen by the IS, Corporate Programs and Investment Consulting Group specialty structure within PFP.

The IS practice focuses on the design, deployment and implementation of sophisticated and complex high value income and transfer tax solutions. These solutions, at times uniquely customized, have also included financial product consulting and design components. PFP's Core tax and financial planning includes more traditional income and transfer tax planning; investment asset allocation, assistance with money manager selection and investment asset performance monitoring; insurance/risk management consulting; cash flow planning; life event planning including corporate change-in control transactions, and retirement and education funding; equity compensation consulting and design; outplacement and separation consulting and related services including tax compliance and planning.

In most U.S. operating offices, the PFP practice's marketplace strategy is tailored to the economics and businesses that drive those markets, hence the national PFP business plan must be flexible yet comprehensive in order to capture appropriate opportunities. As an example of this strategy, in certain U.S. offices, the PFP practice services larger closely held businesses, and in addition to consistent annuity income being generated from the Core Services to these entities' owners/shareholders, these clients have generated significant IS revenue opportunities for KPMG. Alternatively, in certain U.S. offices, the PFP practice has been successful with Corporate Program services generated from larger public corporate entities, likewise these relationships have generated significant IS revenue opportunities. Frequently, the PFP practice designs and delivers its services in coordination with other KPMG practices such as the Compensation and Benefits and the Federal Tax Practice. An example of this joint go-to-market distribution and deployment synergy is SC2 and Option Diversification Vehicle (ODV) and initiatives with Executive Suite. Currently, the PFP practice is beginning to develop a business plan with regard to delivering international tax/PFP services. In this regard, in certain offices and markets in the U.S. and abroad, PFP is working with the International Executive Services (IES) Practice to deliver U.S. and foreign country income and transfer tax services, deployed with the appropriate technical review and KPMG inter-office cooperation, integrated with traditional PFP services.

2. Current Business Model of The Innovative Strategies (IS) Practice

When reviewing IS revenue generated as a component of total PFP revenue in the fiscal years ending in 1996 through 2000, IS gain mitigation solutions have been a primary driver and contributor to both top line and bottom line success. The IS practice over the years has offered and implemented a diverse array of premium solutions for clients that has not been exclusively gain mitigation. These solutions have been designed and implemented to attain both income and transfer tax planning objectives, and have included deferral techniques, as well as investment opportunities. Clients have however historically requested gain mitigation solutions. Since the current landscape has significantly impaired both the client appetite and the IS practice's ability to effectively design and implement these gain mitigation solutions, IS revenue forecasts based upon the current model have been significantly downgraded. This revenue forecast is being experienced by other KPMG practices, also due to the current landscape.

3. Factors Causing a Change in The Current IS Business Model

There are a number of outside factors that have made the success of the IS model difficult to replicate. The most significant factor has been an active U.S. Treasury policy publicly targeting loss mitigation transactions and solutions, as witnessed by Notice 2000-44 released on August 11, 2000. In addition, Internal Revenue Service (IRS) tax shelter regulation projects, including list maintenance requirements, and court cases focusing on forcing taxpayers to demonstrate transaction business purpose and investment and profit motive, have all converged, creating an environment and landscape that has significantly dampened the ability to generate IS revenue and profit levels that have been historically attained with primarily gain mitigation solutions. The chaos of the current environment however, can create opportunity for KPMG.

4. Preliminary Steps in Implementing The New IS Business Model – 30 Days

In creating a new IS business model, there is the opportunity to expand current IS services beyond the tax technology that the current legislative environment has stifled. The new business model will focus on services that give our clients a broader choice of options, and where the KPMG IS professional delivers value as a wealth advisor and not primarily as a tax advisor. The KPMG IS wealth advisory role will lead with introducing and educating our clients as to their alternatives and opportunities beyond tax strategies, by leading with and incorporating solutions for our clients that are financial product based. These financial product-based solutions will include monetization solutions that have been traditionally offered by the investment banks, but that can be designed and engineered by KPMG IS. We are exploring other KPMG practices to work with in this regard to augment the IS skill set. The goal is to start generating revenue now for 6/30/01.

The role of an IS wealth advisor, once the requisite skill set has been attained, is to be able to discern the client's goals, objectives and risk temperament, as we do now as advisors, but to help the client analyze and understand the benefits and consequences of available and customized financial products, for example the workings of a prepaid forwards, puts and calls, short sales, synthetic OID conveyances, and other derivative structures, and the economic assumptions and forward and present value interest rates, and to then be able to compare these structures to innovative tax solutions, for example CTF, IDV, Private Exchange Fund, Private Prepaid and other solutions, all geared to help the client select the best alternative that maximizes their wealth over a time horizon considering their risk tolerance and all other appropriate factors. The result of this business plan approach, based on an investment banking model, is to expand our services beyond tax solutions, provide greater choice to the client with regard to goal attainment, and focus on a lasting client relationship where we are acting as their long-term chief financial officer with regard to the design, implementation, and monitoring of sophisticated entity structures that have elements of both financial product technology and tax technology. We will continue to promote the KPMG brand name, emphasizing independence and objectivity, creativity, innovation and quality design. Longer term, we want to be able to cite a deeper breadth of KPMG resources or/and relationships in the financial product area. The current IS structure will otherwise remain intact for now.

Typically, it is contemplated we would be working with clients in advance of any liquidation transaction, presumably where they own a concentrated investment position(s) with a built-in gain of at least \$ 50 million.

In the marketplace there will be competition, however if we have relationships where we are viewed as creating opportunity for the investment banks with regard to the ability to monetize a concentrated position, and we can work together with the investment banks on financial product implementation and even share the ability to monitor/advise with regard to assets (Stratis), it is anticipated we will not dampen our current investment bank referral base. Our advantage will be our independence as we are able to analyze different product offerings economic assumptions and costs among the banks, where we are not able to place or implement an investment strategy ourselves.

Specific Preliminary Steps – Short Term Action Points – Discuss with Jeff Eischeid

1. Tim to accumulate KPMG white paper discussions on financial products solutions that we can implement immediately. These product solutions as a “Monetization Suite” could include
 - a. Synthetic OID Conveyance Strategy (SOCS)
 - b. 21st Century (SOCS)
 - c. SLEEK
 - d. Private Prepaid
 - e. Private Exchange Fund
 - f. CEDS
 - g. CELS
 - h. Other
- i. In addition, selected Innovative Solutions (Tax) should be considered as offerings
2. Dale and Randy to develop marketing materials considering the solutions cited in 1. above. In addition, create communication pieces.
3. Dale, Tim and Randy Identify an external resource(s) that could work with us to inject financial product knowledge immediately into the process as we now consult with clients. Note T. Speiss Boston client as a test case. Considerations include representatives from Bear Stearns, Montgomery Securities, other. Specific names were discussed.
4. In addition to 3. above, Dale, Tim and Randy to identify internal resources that could work with us to inject financial product knowledge immediately into the process as we now consult with clients. KPMG resources would be especially useful in teaching/educating IS PFP team members as to the strategies and more fundamental components, as well as to help identify other financial product solutions in the marketplace, their applicability, analyzing assumptions, other matters. Specific names were discussed.
5. In addition to 1. and 2. above, continue to work on software tools to depict economics of the alternatives and compare the alternatives. SLEEK and basic prepaid model is complete, CELS is in progress. Tim and David Kohn to continue this process.
6. Dale, Tim and Randy Identify a team of eight to ten KPMG (IS) persons who would be on the task force and would serve as initial beta test Monetization Suite Team members. These persons would become responsible to learn the appropriate financial product solutions, attend any initial training courses, invest the requisite time to be a productive team member, meet with clients of other KPMG offices,

control and direct the information and investment process, be able to explain complex structures and transactions, respond to client questions, meet with investment bankers and boutique firms, learn other solutions in the marketplace, help/lead the implementation process wrt the solutions, work with other IS team members to identify client opportunities. It was discussed having five members from the Northeast area and five members from the West Coast area.

7. We have begun to think about a meeting of the persons identified in 6. above, once steps 1. through 5. are complete (optimally, within 30 days from 12/4/2000).
8. The current IS structure would remain in place unchanged for the time being. The Monetization Suite Team would be created as a component of IS until decided otherwise. We need focus on all IS as cited in the lab meeting of 11/17/2000 (SC2, ODV, LPSD, BIGS, ACDS, IDV, CTF, Other)
9. While the capital markets are volatile and we are approaching year end, the next 45 days could be a prime time to start this initiative

5. Forthcoming after 12/7/2000 Teleconference: Additional Tools, Human Resources and Additional Deployment Assets Needed to Implement The New IS Business Model

Redacted by the
Permanent Subcommittee
on Investigations

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 201

HVB 001161-1165

Credit Request
 Delaware LLC
 September 26, 1999

matched. (See Attachment 3) The swap is designed such that, as the end result of all cash flows on the Loan and the swap, HVB receives LIBOR (without the margin) on USD 53.33 mm for each of the 7 years. At the end of the Loan HVB will receive USD 33.33 mm Loan principal and USD 20 mm swap settlement. If the Loan is prepaid and the swap is terminated at the same time, the algebraic sum of prepayment amount, swap termination payment and swap additional amount, if any, will equal the amount advanced.

- Bankruptcy of LLCs due to a failed investment strategy/inadequate cash flow:

The likelihood of a bankruptcy for any reason other than a failed investment strategy is extremely remote. The LLCs will be single purpose companies and their activities will be limited to the investment strategies contemplated by our agreements. Debt other than that owing to us will be prohibited. We will have a perfected security interest in all collateral.

Furthermore, all collateral will be in possession of the bank. Thus we will have perfected our position through both filings and physical possession. (See Attachment 1)

- Disallowance of tax attributes.

A review by the IRS could potentially result in a ruling that would disallow the structure. In addition, the IRS could possibly amend provisions of the tax code and disallow benefits recognized by the structure or the tax law itself could be changed. We are confident that none of the foregoing would affect the bank or its position in any meaningful way for the following reasons:

1. Disallowance: KPMG has issued an opinion that the structure will most likely be upheld, even if challenged by the IRS. Its opinion is based upon existing case law and provisions of the US Internal Revenue Code. The structure offers the opportunity for investors to make substantial profits over the life of the transaction through the use of a loan structure designed to fit the investment strategy.
2. Tax code amendment or change in law: It is highly unlikely that either would result in a retroactive effect on these transactions. There have been no legislative proposals or draft regulations that might endanger the structure retroactively.

Therefore, it is not likely that the transaction could be challenged successfully.

- Operational Risks

A number of departments in HVB Americas will be involved in various aspects of this transaction. These include:

•

We have spoken to each department and each has agreed that it is capable of fulfilling its responsibilities with respect to this deal. Furthermore, during the closing stage, approximately 4 KPMG staff will be stationed in the bank to assist us with closing and booking issues.

HVB 001166

3631

**Redacted by the
Permanent Subcommittee
on Investigations**

HVB 001167-1175

3632

kpmgPeat Marwick LLP

PFP

To PFP Partners

Date August 5, 1998

From Doug Ammerman
Orange County

Steno jg
Ref a:\opis.doc

OPIS and Other Innovative Strategies

In an effort to help you meet your FY'99 goals, we have decided to give every PFP *partner* the opportunity to market and sell the Offshore Portfolio Investment Strategy (OPIS) and our other innovative strategies. In order to ensure our innovative strategies are properly implemented, designated members of the Innovative Strategies team (listed below) will be available to assist you with technical and implementation issues. Also, because of the sensitive nature of many of our innovative strategies, a "product owner" will be designated for certain innovative strategies (e.g., OPIS). This individual will be responsible for monitoring the marketing, selling, and implementation of his or her specific product(s), and must approve *all* engagement letters and opinion letters issued for such product(s) *before* the letters are sent to clients/targets. The current product owners for OPIS, the Private Annuity Trust (PAT), and the Testamentary Charitable Lead Annuity Trust (TCLAT) are listed below.

In an effort to keep you knowledgeable about our current and new innovative strategies, we will hold periodic video conferences to introduce new strategies and provide a training course on our most popular strategies at the January TMS. In addition, because of the time sensitive nature of OPIS and the apparent confusion associated with this strategy, a discussion of the status of OPIS, and what must be done to market and sell the strategy, follows.

OPIS

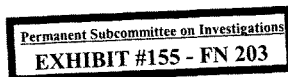
The technical issues associated with OPIS have been settled and approved by DPP-Tax. However, the following three issues remain to be settled before OPIS can be sold to additional clients/targets:

- Independence
- Capacity
- Contingent fee

Independence

Proprietary Material
Confidentiality Requested

KPMG 0026141



kpmgPeat Marwick LLP

Page 2
 PFP Partners
 May 7, 2003

OPIS involves the purchase of stock in a foreign financial institution. Currently, the only institution participating in the transaction is a KPMG audit client (i.e., the only investment option for the client/target is the stock of an audit client). As a result, DPP-Assurance feels there may be an independence problem associated with our participation in OPIS and has indicated that, in order to solve the independence problem, the client/target must have the option to purchase the stock of at least one nonaudit client. Accordingly, Presidio, the investment advisors who implement OPIS, is working to secure at least one additional financial institution (that is not a KPMG audit client) to participate in OPIS. Until such an institution has been secured, KPMG cannot participate in selling or implementing OPIS.

Capacity

The foreign financial institution currently participating in the OPIS transaction is not able to execute any additional OPIS trades (i.e., the institution has reached its capacity). Thus, until one or more additional foreign financial institutions agree to participate in OPIS, clients/targets will not be able to implement the strategy.

Contingent Fee

In the past, KPMG's fee related to OPIS has been paid by Presidio. According to DPP-Assurance, this fee structure may constitute a contingent fee and, as a result, may be a prohibited arrangement if the client/target purchasing OPIS is an audit client or a person in a position of significant influence over an audit client (e.g., the CEO of an audit client or a 20 percent or greater shareholder of an audit client). In addition, contingent fee arrangements are completely prohibited in 19 states. Thus, in order to avoid a contingent fee arrangement (and the problems associated therewith), KPMG's fee must be a *fixed* amount and be paid directly by the client/target. This revised fee arrangement must be used on all future OPIS engagements regardless of the client or the state in which the services are provided. Further, current OPIS engagements that have not been implemented should be renegotiated such that KPMG's fee is fixed and paid directly by the client/target.

We are working with Presidio to resolve these remaining issues and expect to have a final resolution on or before August 14, 1998. We will communicate such resolution to you as soon as possible. In the meantime, while you can discuss OPIS with your clients/targets that have gains of at least \$20 million (subject to their signing a

kpmgPeat Marwick LLP

Page 3
PFP Partners
May 7, 2003

confidentiality agreement), you may not sell or implement the transaction at this time. Also, keep in mind that the transaction takes approximately 90 days to complete. Thus, once we are able to sell and implement OPIS, clients generally must enter into the transaction before October 1, 1998 in order to complete the entire transaction in 1998.

Designated Innovative Strategies Team Members

Randy Bickham, *Senior Manager* (Mountain View)
650-404-5385

John Gardner, *Senior Manager* (WNT)
202-467-3870

Brent Lipschultz, *Senior Manager* (WNT)
202-530-6874

Shannon Liston, *Senior Manager* (New Orleans)
504-584-????

Justin Ransome, *Senior Manager* (WNT)
202-467-3800

Mark Watson, *Partner* (WNT)
202-467-2433

Current Product Owners

OPIS Jeff Eischeid, *Partner* (Atlanta)
 404-222-3180

PAT Mark Watson

TCLAT John Gardner

Proprietary Material
Confidentiality Requested

KPMG 0026143

Message0002	
Subject:	RE: SC2
From:	Brockway, David H
Date:	12/31/2001 9:56:18 AM
To:	Smith, Richard H (US/WEST AMP)
Message Body	
<p>I guess it doesn't surprise me, but I sort of thought Larry might have waited until we had a call amongst ourselves before taking it to the top. I guess he couldn't wait to see the fireworks.</p> <p>-----Original Message----- From: Smith, Richard H (US/WEST AMP) Sent: Monday, December 31, 2001 9:27 AM To: Brockway, David H Subject: FW: SC2</p> <p>David,</p> <p>I could not tell whether you included Larry in your 12/21 message below with the expectation that he could not help himself from forwarding it to the broader group. In any event, it seems to have peaked some interest.</p> <p>Richard</p> <p>-----Original Message----- From: Rosenthal, Richard P Sent: Sunday, December 30, 2001 2:26 PM To: DeLap, Larry; Manth, Larry E; Rosenthal, Joan Cc: Brockway, David H; Kelliher, William B; Smith, Richard H (US/WEST AMP); Atkin, Andrew S; Elgin, Evelyn Subject: RE: SC2</p> <p>Joan, please coordinate a conference call for end of next week to discuss the topic of these e-mails. Thanks.</p> <p>Happy New Year everyone.</p> <p>Rick</p> <p>-----Original Message----- From: DeLap, Larry Sent: Saturday, December 29, 2001 7:55 PM To: Larry E Manth (E-mail) Cc: David Brockway (E-mail); Kelliher, William B; Richard Smith (E-mail); Richard Rosenthal (E-mail); Atkin, Andrew S; Evelyn Elgin (E-mail) Subject: FW: SC2</p> <p>Larry -</p> <p>We had a verbal agreement following a conference call with Rick Rosenthal earlier this year that SC2 would not be mass marketed.</p>	
<p>Proprietary Material Confidentiality Requested</p> <p>KPMG 0050562</p>	

file://W:\data\U06107583\700\BrockwayHD\David%20Brockway%20HD%20HTML%20Email\db0303[17... 8/23/2003

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 223

In any case, the time has come to formally cease all marketing of SC2. Please so notify your deployment team and the marketing directors.

Larry

-----Original Message-----

From: Brockway, David H
Sent: Friday, December 21, 2001 2:57 PM
To: Kelliher, William B
Cc: DeLap, Larry; Smith, Richard H (US/WEST AMP)
Subject: RE: SC2

It looks like they have already tried over 2/3rds of possible candidates already, if I am reading the spread sheet correctly. Could you set up a conference call at a convenient time after the holidays for you, Larry, Richard and I, so we can all review the bidding. I have a feeling the horse is already out of the barn, but let's discuss the situation and see if there anything that should be done at this point. Thanks.

-----Original Message-----

From: Kelliher, William B
Sent: Thursday, December 20, 2001 3:30 PM
To: Brockway, David H
Subject: FW: SC2

Dave:

I was copied on the message below, which appears to indicate that the firm is intent on marketing the SC2 strategy to virtually every S corp with a pulse (if S corps had pulses). Going way back to Feb. 2000, when SC2 first reared its head, my recollection is that SC2 was intended to be limited to a relatively small number of large S corps. That plan made sense because, in my opinion, there was (and is) a strong risk of a successful IRS attack on SC2 if the IRS gets wind of it. Somewhere along the line, that marketing plan seems to have changed. According to the list attached to the message below, the intimate group of S corps potentially targeted for SC2 marketing has now expanded to 3,184 corporations. Call me paranoid, but I think that such a widespread marketing campaign is likely to bring KPMG and SC2 unwelcome attention from the IRS. If so, I suspect a vigorous (and at least partially successful) challenge would result. I realize that the fees are attractive, but does the firm's tax leadership really think that this is an appropriate strategy to mass market?

Bill

-----Original Message-----

From: Nance, Shelly
Sent: Thursday, December 20, 2001 9:12 AM
To: US-WNT S-Corporation Charitable Contribution Strategy
Subject: SC2

I have attached the Monthly OMS Activity Report for "SC2", and in addition the report will be posted to the "SC2" Outlook Deployment folder. We hope that the attached file will provide you with the necessary tools to further the success and measure the performance of your solution and will serve as the center of your discussion on your bi-weekly solution deployment team calls.

Proprietary Material
Confidentiality Requested

KPMG 0050563

The file contains a summary report of market activity from OMS for your solution. Please, review it and provide any new information to your Area Marketing Directors (Names Below) so that they can include it in OMS. In particular, look for all opportunities that have not shown any progress since last month (Selling Cycle Date clearly marked) and determine why the deal has stalled and what help you need to move it forward.

The file is sorted by area, selling cycle step and then alpha by target that you can easily pull out your specific area.

Tax Marketing Directors:

Mid-Atlantic Marsha Shelton Tysons Corners 703-747-6946
Midwest Christine Elliot Chicago 312-665-2709
Northeast Rita Bacas New York 212-872-7909
Southeast Trish McGinty Atlanta 404-614-8662
Southwest Jonathan Pullano Dallas 214-840-4055
West Melissa Fiorina San Francisco 415-951-7123

Thank You!

<< File: SC2 12-19.XLS >>

Shelly Nance
National Assistant OMS Administrator
219-423-6818
kpmg

Outlook Header Information

Conversation Topic: SC2
Subject: RE: SC2
From: Brockway, David H
Sender Name: Brockway, David H
To: Smith, Richard H (US/WEST AMP)
Delivery Time: 12/31/2001 9:56:18 AM
Creation Time: 12/31/2001 9:56:15 AM
Modification Time: 12/31/2001 9:56:18 AM
Submit Time: 12/31/2001 9:56:18 AM
Importance: 121
Priority: 120
Sensitivity: 120
Flags: 121
Size: 1210800

Proprietary Material
Confidentiality Requested

KPMG 0050564

file://W:\data\J06107583\700\BrockwayHD\David%20Brockway%20HD%20HTML%20Email\db0303[17... 8/23/2003

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
 Sent: Friday, October 01, 1999 4:58 PM
 To: Ammerman, Douglas K; Eischeid, Jeffrey A; Watson, Mark T
 Subject: FW: BLIPS



FW BLIPS
 Representations.rtf
 Gentlemen -

We also agreed that:

18 OPIS "slots" were reserved for the intended BLIPS participants noted in the third paragraph below. To the extent those slots are not filled by the intended BLIPS participants, they may be offered to individuals who were on the "grandfathered" list of OPIS potential participants (those individuals to whom an OPIS presentation was made in 1998, but who did enter into an OPIS transaction). No more than 18 OPIS transactions will be entered into and they will be entered into only with persons from one of the two preceding groups.

A year 2000 BLIPS transaction may be entered into with respect to individuals to whom BLIPS has already been presented and whom have expressed an interest in a year 2000 BLIPS transaction. Jeff Eischeid has a list of such "grandfathered" BLIPS potential participants and will see that year 2000 BLIPS transactions are entered into only with persons on that list.

Larry

> -----Original Message-----
 > From: DeLap, Larry
 > Sent: Friday, October 01, 1999 3:15 PM
 > To: Ammerman, Douglas K; Eischeid, Jeffrey A; Watson, Mark T
 > Subject: BLIPS
 >
 >
 > <<FW BLIPS Representations.rtf>>
 >
 > Gentlemen -
 >
 > I refer to condition #11 of the attached message relative to the marketing
 > of BLIPS.
 >
 > We have had various discussions thereon over the last nine days. My
 > understanding of the discussions is that we have agreed that marketing of
 > BLIPS has ceased and that no more BLIPS transactions will be marketed.
 >
 > We also discussed a specified number of instances (less than 20) where an
 > engagement letter had been concluded with a client for a BLIPS
 > transactions, but a capacity problem arose with Presidio. We agreed that
 > with respect to those particular identified clients, but only those
 > clients, it would be permissible to enter into an OPIS engagement,
 > assuming the client agreed to an OPIS engagement.
 >
 > We further discussed a specified number of other instances (about 20)
 > where a perceived commitment to a BLIPS transaction had been made, but an
 > engagement letter had not been signed. We agreed that with respect to
 > those particular identified clients as well as any clients mentioned in
 > the preceding paragraph who do not enter into an OPIS engagement, but only
 > those clients, it would be permissible to enter into a particular

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 223

KPMG 0011714

3639

> "enhanced BLIPS" transaction suggested by Randy Bickham, provided
> Washington National Tax approves the enhanced transaction from a technical
> standpoint.
>
> If your understanding varies from the above, please get back to me.
>
> Larry

3640

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Friday, October 01, 1999 3:15 PM
To: Ammerman, Douglas K; Eischeld, Jeffrey A; Watson, Mark T
Subject: BLIPS



FW BLIPS
Representations.rtf

<<FW BLIPS Representations.rtf>>

Gentlemen -

I refer to condition #11 of the attached message relative to the marketing of BLIPS.

We have had various discussions thereon over the last nine days. My understanding of the discussions is that we have agreed that marketing of BLIPS has ceased and that no more BLIPS transactions will be marketed.

We also discussed a specified number of instances (less than 20) where an engagement letter had been concluded with a client for a BLIPS transactions, but a capacity problem arose with Presidio. We agreed that with respect to those particular identified clients, but only those clients, it would be permissible to enter into an OPIS engagement, assuming the client agreed to an OPIS engagement.

We further discussed a specified number of other instances (about 20) where a perceived commitment to a BLIPS transaction had been made, but an engagement letter had not been signed. We agreed that with respect to those particular identified clients as well as any clients mentioned in the preceding paragraph who do not enter into an OPIS engagement, but only those clients, it would be permissible to enter into a particular "enhanced BLIPS" transaction suggested by Randy Bickham, provided Washington National Tax approves the enhanced transaction from a technical standpoint.

If your understanding varies from the above, please get back to me.

Larry

3641

Unknown

From: Hastings, Carl D
Sent: Thursday, October 14, 1999 12:54 PM
To: Paula, Robin M
Subject: FW: Year 2000 Blips Transactions

FYI

CDH

-----Original Message-----

From: Baumann, Dale R
Sent: Wednesday, October 13, 1999 7:09 PM
To: Hastings, Carl D
Cc: Escheid, Jeffrey A; Ito, Dennis A
Subject: RE: Year 2000 Blips Transactions

No marketing to clients who were not on the BLIPS 2000 list. The BLIPS 2000 list were for those individuals who were approached before Larry told us to stop marketing the strategy who were interested in doing the deals for the year 2000. I would think we could also possibly do a deal for someone who was originally only looking for a 1999 transaction but ended up coming back to us wanting to do a deal for 2000.

Jeff - comments on the last sentence?

-----Original Message-----

From: Hastings, Carl D
Sent: Wednesday, October 13, 1999 4:27 PM
To: Baumann, Dale R
Subject: RE: Year 2000 Blips Transactions

I thought we were told to quit marketing 200 BLIPS transactions. Does this relate to those that were sold before the stop sign?

Carl

-----Original Message-----

From: Baumann, Dale R
Sent: Wednesday, October 13, 1999 11:02 AM
To: Carl Hastings; Dale Baumann; David Rivkin; George McCrinisk; John Nuckolls; Randall Bickham; Robin Paule; Shannon Liston
Cc: Ito, Dennis A
Subject: FW: Year 2000 Blips Transactions

FYI

-----Original Message-----

From: Escheid, Jeffrey A
Sent: Wednesday, October 13, 1999 5:05 AM
To: Baumann, Dale R
Cc: Ito, Dennis A
Subject: RE: Year 2000 Blips Transactions

Totally agree. Let's get the engagement letters.

-----Original Message-----

From: Baumann, Dale R
Sent: Tuesday, October 12, 1999 8:03 PM
To: Escheid, Jeffrey A
Cc: Ito, Dennis A
Subject: Year 2000 Blips Transactions

Jeff,

When you get caught up, you may want to send out a memo on the year 2000 BLIPS transactions. I am getting questions on whether we should have the prospects sign engagement letters for those deals now if the client has

1

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 227

KPMG 0006485

3642

decided that they definitely want to do the deal.

I spoke to Randy about timing for starting 2000 deals and he thought Presidio and DB would be ready to go in January. By that time, the 1999 deals will be fully processed by Presidio and the loans should be off the books of DB so they will have loan capacity.

Is it ok to allow Shannon and David to get signed engagement letters for two of the 2000 transactions? It would seem to me that we should lock up these individuals under an engagement letter as soon as possible so they are not tempted to go with another provider. Also, they can gather all the background documentation now so that they are ready to go in January.

Dale Baumann

kpmg Silicon Valley Office - Mountain View

☎ (650) 404-5307

☎ (650) 960-0952

✉ dbaumann@kpmg.com

From: Dan McNamara
Sent: Thursday, September 30, 1999 10:40 AM
To: Christopher Hirata
Subject: FW: OPIS

-----Original Message-----

From: Norm Bontje
Sent: Thursday, September 30, 1999 7:57 AM
To: Larry Scheinfeld; Jeff Greenstein; Dan McNamara
Subject: RE: OPIS

We should, at this point, have people call Dan McNamara or me. Prior to doing anything, we need to talk to a technical person at kpmg to discuss how the trade gets executed, by when, with what counterparties, etc. WE CANNOT just start taking orders without this discussion. This is imperative

-----Original Message-----

From: Larry Scheinfeld
Sent: Thursday, September 30, 1999 5:40 AM
To: Norm Bontje; Jeff Greenstein; Dan McNamara
Subject: FW: OPIS

<< File: OPIS trades 9_29.xls >> Please call me and let me know who the KPMG folks should start to call with the orders. I need to call Jeff E. as soon as possible.

-----Original Message-----

From: Eischeid, Jeffrey A [<mailto:eischeid@kpmg.com>]
Sent: Thursday, September 30, 1999 6:45 AM
To: 'Stolz, Wolfgang'
Cc: 'Scheinfeld, Larry'; Ammerman, Douglas K
Subject: OPIS

Attached is my most recent estimate of the redemption trades we expect to bring to Quadra and UBS over the next couple of weeks. As you know, these trades are not certain until they close. I expect a few of them will fall out. On the other hand, I expect a few additional clients will want to pursue the opportunity. In any event, it looks like the number of transactions will be slightly below 20 and the loan volume will be no more than \$600 million. Given the short period of time left to execute these trades in 1999, it would be quite amazing if we could execute this volume.

Jeff

<<OPIS trades 9_29.xls>>

 The information in this email is confidential and may be legally privileged. It is intended solely for the addressee. Access to this email by anyone else is unauthorized.

If you are not the intended recipient, any disclosure, copying, distribution or any action taken or omitted to be taken in reliance on it, is prohibited and may be unlawful. When addressed to our clients any opinions or advice contained in this email are subject to the terms and conditions expressed in the governing KPMG client engagement letter.

Permanent Subcommittee on Investigations EXHIBIT #155 - FN 232
--

QLS004593

Memorandum

To: Christopher Thorpe, Vera McVey, Edgar Nubert
CC: Richard Pankuch, Dom DeGiorgio, Bill Tsai, Alex Nouvakhov
From: Ted Wolf, Sylvie DeMetrio
Date: 8/19/2003
Re: Presidio

Upon the request of Christopher Thorpe and the Credit Committee, the following groups within the bank were approached in an effort to determine the operational status of the back office, as well as the impact of an increase in the Presidio credit line. The proposed increase will bring the line to \$2.25 billion from \$1.5 billion under which the past deals have been executed. The questions posed to the three departments surrounded the impact of the increase in dollar amount on their workload and whether the groups were comfortable with the current process. They were asked if there was sufficient lead-time and contact with Financial Engineering should clarity be necessary.

1. Back Office Operations:

Clairmonte David, Beatrice Babgoni, Michele Brooks, Marshall Terry

For this group, the size of the trading program is irrelevant. The concern is the mismatching between money market and foreign exchange trades. Specifically the mismatching occurs in the value dates, maturity dates and the dollar amounts of the transactions and deposits. Financial Engineering has addressed this concern. Alex Nouvakhov now monitors the cash accounts and maintains close watch over all transactions to insure the amounts match and are correct. If a problem arises, it is detected early and solved quickly with the help of Michele Brooks. Together the two groups monitor the transactions very closely.

Secondly, Operations expressed concern over the unwind of the transactions, usually set 65 days after the swap. The nature of the concern is similar to the first, the accounts need to be watched to insure that the correct amounts and dates flow in and out of the accounts. Again, the solution is the examination of the transactions and accounts by Mr. Nouvakhov as the unwind occurs. Operations has confirmed that since Mr. Nouvakhov has been heavily involved

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 235

HVCD00001

August 19, 2003

in the process, things have proceeded much smoother for the teams that comprise Back Office Operations.

Marshall Terry, the attorney who oversees all of the legalities concerned with back office operations, raised the third issue, Operations does not receive the swap confirmations on a timely basis. Financial Engineering has contacted Shearman & Sterling (the attorneys that work for the Bank) in order to insure that the confirms are sent back in a timely manner to eliminate any legal risk to the Bank. Through coordination with Mr. Terry and Matt Kerfoot, the attorney at Shearman, we have addressed the points at which the documents are deterred, and we are in the process of determining a solution that will expedite the movement of the confirms on a more efficient time line.

Ms. Babgoni stressed the point that none of the deals should settle close to the end of the year. All transactions should be closed out before December 15, 2000.

2. Loan Servicing:

Debbie Masters

Ms. Masters shared the procedures she has in place for her team to demonstrate her comfort level with the Presidio deals. She is confident that an increase in dollar amount and volume can easily be accommodated. In an effort to address the increase in dollar amount and volume of the Presidio deals, Ms. Masters has begun training additional members of her team on the procedures of the Presidio loans. Hence, there will be more people within Loan Servicing familiar with Presidio and able to expedite the loans.

3. Risk Control Analysis:

Jennifer Fitzgibbon

The dollar amount of the transactions is of no great concern. We discussed the issue relating to the 8 days differential between loan date and swap rate set date. In fact, the swap rate is set 8 days later, but the starting date of the swap is set retroactively to the same date as the loan date, so there is no risk to HVB. It has been acknowledged that the risk is purely a theoretical one for that 8 days. However, Ms. Fitzgibbon's concern centers on the retroactive change to the Bank's books of record. Greg Marposon, in Treasury, has indicated in a meeting that he is working on an alternate structure to address this issue.

Ms. Fitzgibbon also raised concern about the unwinds with respect to the movements in and out of the accounts resulting from the trading program. Financial Engineering is addressing her concern by assigning Mr. Nouvakhov to work closely with the back office and RMP to maintain ownership of the clients' activities.

Presidio Advisory Services
Deal List - Tranche #2

Deal #	Investor	Buyer	Principal Fund	Notional \$	T-1 Preclosing	T Closing	T + 6 Preclosing	T + 7 Closing
2				\$ 50,000,000	Hart 10/14/99	10/15/99	10/25/99	10/26/99
3				\$ 28,000,000	Hart 10/15/99	10/18/99	10/26/99	10/27/99
				\$ 1,000,000				
				\$ 1,000,000				
				\$ 46,000,000				
4				\$ 28,500,000	Hart 10/15/99	10/18/99	10/26/99	10/27/99
				\$ 28,500,000				
				\$ 57,000,000				
5				\$ 22,500,000	Hart 10/14/99	10/18/99	10/26/99	10/27/99
6				\$ 10,000,000	Hart 10/15/99	10/18/99	10/26/99	10/27/99
7				\$ 17,000,000	Hart 10/15/99	10/18/99	10/26/99	10/27/99
8				\$ 8,000,000	Hart 10/18/99	10/19/99	10/27/99	10/28/99
				\$ 10,000,000				
				\$ 5,000,000				
				\$ 6,000,000				
				\$ 29,000,000				
9				\$ 34,000,000	Hart 10/14/99	10/18/99	10/26/99	10/27/99
10 a				\$ 16,000,000	Hart 10/18/99	10/19/99	10/27/99	10/28/99
b				\$ 7,000,000				
c				\$ 4,000,000				
d				\$ 4,500,000				
				\$ 35,500,000				
11 a				\$ 11,000,000	Hart 10/18/99	10/19/99	10/27/99	10/28/99
b				\$ 2,000,000				
c				\$ 5,000,000				
d				\$ 2,000,000				
				\$ 20,000,000				
12				\$ 35,000,000	Hart 10/14/99	10/18/99	10/26/99	10/27/99
				\$ 356,000,000				
Deal List T2			Tranche #2					10/14/99 10/17/99

Preñido Advisory Services, LLC
Deal List - Tranche 4 (HVB)

Deal #	Investor	Fund	Borrower	National \$	T-3	Priced/Issued	Chasing	Bidding	Pre-bidding	Closing	T-1	T-2	T-3	T-4	Pre-bidding	Closing	T-1	T-2	T-3	KENNY Contact
1a				\$25,000,000																
1b				20,000,000																
1c				20,000,000																
1d				20,000,000																
2a				10,000,000	2/8/2000	2/15/2000	2/14/2000	2/17/2000	2/23/2000	2/25/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Stuebner
2b				10,000,000																
2c				2,000,000																
2d				2,000,000																
2e				2,000,000																
2f				4,000,000																
2g				30,000,000	2/24/2000	3/2/2000	3/2/2000	3/6/2000	3/6/2000	3/13/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Cross
3				55,000,000	3/30/2000	4/8/2000	4/7/2000	4/10/2000	4/13/2000	4/17/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Bloom/Poreba
4				30,000,000	2/8/2000	2/15/2000	2/16/2000	2/17/2000	2/23/2000	2/25/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Riddick/Daghenas
5a				8,000,000																
5b				12,000,000																
5c				15,000,000	2/10/2000	2/17/2000	2/18/2000	2/22/2000	2/25/2000	2/29/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Gray
6				20,000,000	4/11/2000	4/18/2000	4/19/2000	4/20/2000	4/25/2000	4/27/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Hasting/Paula
7a				10,000,000																
7b				10,000,000	5/15/2000	5/22/2000	5/23/2000	5/24/2000	5/30/2000	6/1/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Brennan
8				21,000,000	6/17/2000	6/18/2000	6/20/2000	6/21/2000	6/28/2000	6/29/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Hasting/Paula
9				20,000,000	4/28/2000	5/5/2000	5/6/2000	5/6/2000	5/12/2000	5/13/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Hasting/Paula
10				76,000,000	4/28/2000	5/5/2000	5/6/2000	5/6/2000	5/12/2000	5/13/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Baumann
11a				15,133,000																
11b				15,133,000																
11c				4,884,000																
11d				3,650,000	6/15/2000	6/22/2000	6/23/2000	6/24/2000	6/30/2000	6/1/2000	Fri	Mon	Tue	Wed	Fri	Mon	Tue	Wed	Thu	Sandz Szulc

2006-07-10 10:00 AM

9/4/2003 10:59 AM

Redacted
by
Permanent Subcommittee
on Investigations

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 235

HVCN 00018

Prestige Advisory Services, LLC
Deal List - Tranche 4 (HTB)

Deal #	Investor	Borrower	Fund	National \$	T-6	Pre-closing T-1	Closing T	Borrowing T+1	Pre-closing T+4	Closing T+7	T+8	T+9	KPMG Contact
12				100,000,000	6/15/2000	6/22/2000	6/23/2000	5/24/2000	5/29/2000	6/1/2000	6/5/2000	6/6/2000	Warley
13a				30,000,000									
13b				1,000,000									
13c				700,000									
13d				1,500,000									
				34,100,000	6/12/2000	6/19/2000	6/20/2000	6/21/2000	6/26/2000	6/28/2000	6/30/2000	7/3/2000	Fergus
14				50,000,000	6/12/2000	6/19/2000	6/20/2000	6/21/2000	6/26/2000	6/28/2000	6/30/2000	7/3/2000	Henderson
15				41,000,000	7/1/2000	7/17/2000	7/18/2000	7/19/2000	7/24/2000	7/27/2000	7/28/2000	7/31/2000	Paule
16				45,000,000									Rivkin/Hell
17a				16,000,000									
17b				1,000,000									
17c				30,000,000	7/15/2000	7/17/2000	7/18/2000	7/19/2000	7/24/2000	7/27/2000	7/28/2000	7/31/2000	Carbo
18				30,000,000	7/15/2000	7/17/2000	7/18/2000	7/19/2000	7/24/2000	7/27/2000	7/28/2000	7/31/2000	Paule
19				35,000,000	7/15/2000	7/17/2000	7/18/2000	7/19/2000	7/24/2000	7/27/2000	7/28/2000	7/31/2000	Ivins/Monahan
20				20,000,000									Spells
				\$79,100,000									

Redacted
by
Permanent Subcommittee
on Investigations

9/4/2003 10:55 AM

Deal#7-10-00-34

HVCD 00019

GB Americas	Rel./Product Mgr.: Pankuch	CRM/ SCRM: Wolf	ZBRM: Industry/Prod./Region: Thorpe/McVey
MT: Fin. Eng.	Phone: 212-672-5727	Phone: x5399	Phone:

Amount In ☒ TEUR (Exchange Rate)**Corporate Banking Division-Credit Request** dated: 1/06/00**Type of Request:**

- ☐ New Group
☐ Review
☒ Increase/Extension
☐ Other Amendment

Approval

Authority: Credit Comm.

Next Review

On:

- ☐ Organized
☐ Positive Acknowledgement of Board Required
☐ Supervisory Report Required
☐ Copy to KRC9

Group:	Presidio Advisory Services			Conforms with Credit Policy?
Industry:		SIC:		<input checked="" type="checkbox"/> Yes
Rating:	2 (Previous)	Customer Since:	1999	<input type="checkbox"/> No (Justification See No. 5)
External Ratings:	S&P: N/A	Moody's: N/A	KMV (EDF): N/A	Other:

1. Relationship Strategy:**Tendency:**

- ☒ Increase ☐ Constant ☐ Decrease

Group Earnings

	Gross	DB3	of that: Credit	DB5
Previous Year	4.45m	4.42m	Infinite	4.42m
Current (12/99)				
Projected *	14.1m	14m	Infinite	14m
Applied for	0.5 year	0.5 year	ROEC	0.5 year

* up to 30.06. current year, from 1.7. following year

Comment:

HVB Structured Finance seeks approval of a platform to fund (on a revolving basis for ten months), a series of 7 year collateralized premium loans - principal plus premium totaling USD 1.5 billion (the "Loans") - plus associated swaps to several special purpose Delaware LLCs, each of which will be a "Borrower". The purpose of the Loans is to finance investment activities of limited liability companies organized under the laws of the state of Delaware ("Delaware LLCs"), each of which at inception is owned by an individual(s) or a trust(s). We will book new loans under this facility on an ongoing basis to the extent that loans are prepaid prior to October 31, 2000. The number of transactions booked at any time will not exceed 10. Included in the platform will be transactions for the principals of Presidio itself. The latter transactions will employ a slightly different structure than that used for the remainder of the platform, but the risk analysis remains the same. In the early stages the Loans will be secured by an investment portfolio of money market securities, investments in money market funds and/or USD and EUR or other major currencies (or other permitted investments -see below), all on deposit with, or otherwise under the control of, HVB.

If the platform is only used once and the loans are repaid on the six month anniversary of the borrowing date, DB 5 will be \$7million. Given the virtual certainty that all amounts owing will be fully cash collateralized for at least 6 months, capital allocation is based on 0% risk assets, making the ROEC on this transaction infinite for the first 180 days. For the remaining term of the Loans the ROEC will change depending on the nature of the collateral. In addition, we expect our Treasury Department to earn an additional profit of roughly 15 bps on the Stated Principal on the bid-offer spread on trades made through them by the LLCs. Earnings potential for the Treasury should exceed 0.1% (USD 1.5 million for each time the platform turns over).

In October, 1999 we booked USD 950 million (out of USD 1.03 billion approved) in exposure (Premium plus Principal), all cash collateralized. We were repaid in full on December 29, 1999, having earned USD 4.45 million. In addition, NY Treasury earned approximately USD 1 million on its activities (FX, deposits, swaps and caps) with respect to the transaction.

While the current request represents a potential increase in dollar exposure, it does not represent an increase over the previous approval in total number of deals. The maximum number of transactions in place at any time will be 10. The primary risks in this structure are operational, relating directly to the number of trades and associated accounting entries. Because we now have experience in all operational aspects of the structure, we believe risk to the bank will actually decrease, notwithstanding the increased dollar amount. In addition to the operational risks, there also exist documentary risks. Having been through the transaction once we are completely confident that these risks are under control. (We will continue to use Shearman & Sterling as counsel in documentary matters.)

We request that SRM Americas be authorized to approve each individual investor (deal) under the Platform.

Pursuant to our collateral formulas, the net exposure, after hedges, should never exceed our collateral. (Required collateral margin 101.25%)

2. Credit Exposure / Collateral: ☒ HypoVereinsbank AG ☒ HVB-Group Pfaff (incl. approved credit lines of subs.)

	Repayment Risk Incl. Guarantees, Billets of Exchg., Direct Debts	+ Replace-ment Risk	+ Insur Risk*	+ (Other Risks)	Total Credit Exposure	Correction Credit Exposure	Credit Exposure (Approval Limit I)	Not Covered Risk Portion	Settlement Risk = Credit Exposure (Approval Limit II)
Limit (K) /									
Pfaffs (P)	\$ 1.5 bil	\$ 720 m			\$ 2.22 bil		\$ 2.22 bil		\$ 3.563 bil
Thereof: New	\$ 1.5 bil	\$ 720 m			\$ 2.22 bil		\$ 2.22 bil		\$ 3.563 bil
Thereof:									
Tenor > 1 Year	\$ 1.5 bil	\$ 720 m							
Thereof: New									
* exclude if global limits applicable									
Customer Group Indebtedness (BBK): Dated:					Total / Number of Banks: 1 Thereof: HVB				
HypoVereinsbank Group Risk (Total):					\$ 2.22 bil				

3. Background (Counterparty / Purpose of Transaction):

Presidio Advisory Services is an investment advisory company whose founders are former KPMG tax specialists. It creates investment products, which it markets through KPMG's network to high net worth individuals. Bank loans are required to facilitate the implementation and leverage of the investment strategies. HVB has been doing business with the principals, Messrs. Pfaff and Larson, since 1997. All transactions were completed successfully.

The purpose of the facility requested here is to facilitate a specific investment strategy offered to high net worth individuals for the shorting of certain foreign currencies pegged to the USD.

4. Analysis for the Group :

Method: Rating for International Rating for Corporate Customer

Financial Condition				
Amounts in		%	%	%
Tot Net Sales	N/A			
EBITDA	N/A			
Net Profit	N/A			
Total Liabilities	N/A			
Total Net Worth	N/A			
Total Assets	N/A			
EBITDA / (Tot.Int. + CMLTD)	N/A			
Cash after Operations	N/A			
Cash after Cap-Exp./Investments	N/A			
Debt/EBITDA	N/A			
Debt/Capitalization	N/A			
	N/A			

Management Assessment:

Principal:	Principal:	Principal:	Contact:
John M. Larson	David Amir Makov	Robert A. Pfaff	
<p>---- From 1997 to 1999, Mr. Larson has been a Managing Director of Presidio Advisory Services, a San Francisco based investment advisory firm. From 1985 to 1997, Mr. Larson was a Senior Manager for KPMG.</p> <p>---- From 1997 to 1999, Mr. Pfaff has been a Managing Director of Presidio Advisory Services, a San Francisco based investment advisory firm. From 1985 to 1997, Mr. Pfaff was a Partner for KPMG.</p> <p>---- From 1997 to 1999, Mr. Makov has been a Managing Director of Presidio Advisory Services, a San Francisco based investment advisory firm. From 1997 to 1999, Mr. Makov was a co-founder/co-manager of a USD 150mm private investment fund. From 1996 to 1997, Mr. Makov served as Director of the Global Private Capital Group of Deutsche Morgan Grenfell. Prior to that, he was a Vice President at Merrill Lynch in the Industry Specialist Group. Prior to that, Mr. Makov was a trader and a portfolio manager at Long Term Capital Management.</p> <p>Mr. Pfaff has been known personally to FNE for 8 years. Mr. Larson has been known personally for 5 years. In 1997 and 1998 HVB concluded 5 transactions with Messrs. Pfaff and Larson. All was concluded successfully. We have the highest regard for both gentlemen.</p>			

5. Summary:

o Risks/Mitigants, Recommendation:

Risks

- HVB's collateral pools, which include all investments and/or supporting cash deposits, decrease in value.

We are protected in our documentation through a minimum overcollateralization ratio of 1.0125 to 1 at all times. Collateral values (mark to market) are reported daily by Risk Controlling and the ratio calculated by FNE. Violation of this ratio triggers immediate acceleration under the loan agreements without notice and immediate repayment.

The Permitted Investments (See Attachment 1) included in our agreements are either extremely conservative in nature with little exposure to interest rate risk (maximum 90 day tenor) or have no collateral value for margin purposes (interest rate swaps and options). These Permitted Investments are those contemplated by the investment manager during Phases I and II of the program. Phase III anticipates a much more aggressive mix of investments (yet to be determined) which, however, would require our agreement to amend our loan documents to permit additional investments, which means that we would have an option to exit the transaction. Any changes would have to be approved by SRM Americas and SRM Special Products.

As a practical matter, all of the risk investments will be hedged either by, or through, HVB. The investment LLCs will enter forward agreements with HVB to sell EUR and buy USD forward to hedge its EUR deposits. HVB Treasury will assume responsibility for hedging the HKD, ARS and potential other forward positions into which it enters with the investment LLCs.

- Interest rate risk associated with prepayment of the loan.

The risk arises because the investments made by the LLCs are floating rate and their loan repayment obligation is fixed rate. To hedge the interest rate basis mismatch, LLCs will enter into interest rate swaps with HVB Risk Management Products. LLCs will receive 17.8% on USD 937.5 million notional and will pay 1 month LIBOR on USD 1.5 billion notional to HVB. On maturity date (7 years later), investment LLCs will also pay HVB USD \$62.5 million, so both coupon and principal payments are matched. The swap is designed such that, as the end result of all cash flows on the loan and the swap, HVB receives LIBOR (without the margin) on USD 1.5 billion for each of the 7 years. If the loan is prepaid and the swap is terminated at the same time, the algebraic sum of loan prepayment amount, swap termination payment and swap additional amount, if any, will equal the amount owing to us.

- Bankruptcy of LLCs due to a failed investment strategy/inadequate cash flow:

The likelihood of a bankruptcy for any reason other than a failed investment strategy is extremely remote. The LLCs will be single purpose companies and their activities will be limited to the investment strategies contemplated by our agreements. Debt (other than a nominal amount) other than that owing to us will be prohibited. We will have a perfected security interest in all collateral. Furthermore, all collateral will be in possession/control of the bank.

- Disallowance of tax attributes.

A review by the IRS could potentially result in a ruling that would disallow the structure. In addition, the IRS could possibly amend provisions of the tax code and disallow benefits recognized by the structure or the tax law itself could be changed. We are confident that none of the foregoing would affect the bank or its position in any meaningful way for the following reasons:



- Operational Risks

We have established and tested procedures for working with all parties involved in the transaction. The procedures were refined through experience with the first series of transactions, which was successfully booked and unwound during the last three months of 1999. Departments with which we have cooperated closely include:

Credit Risk Management	Cash Management	Risk Management Products
Treasury	Tax	Risk Controlling
HVB Capital Markets	Customer Loan Servicing	Accounting Back Office/Treasury

- Due Diligence

HVB will accumulate substantial "Know Your Customer" background information on each investor to ensure both his/her financial sophistication and that our structure is not being used for illegal purposes. Each investor will be individually reviewed, recommend and approved by SRM Americas.

References

We have established an excellent, close working relationship with all three principals of Presidio and now know them personally. They are first rate professionals, extremely competent in their areas of expertise.

Credit References

We contacted Deutsche Bank, which has closed approximately seven billion dollars of transactions similar to the one presented here. In September, 1999, the Deutsche Bank representative stated that they had been doing business with Presidio for approximately three years and had closed approximately USD 7 billion in transactions up to that point. Their experience has been excellent and they have the highest regard for Presidio's principals.

Recommendation

In view of extremely low risk and high profit potential of this transaction and those to follow we recommend approval.

o Covenants/Other Conditions:	Deadline	Responsible Unit
Covenants: <ul style="list-style-type: none"> • No consolidation, merger, sale of assets except pursuant to our agreements • No liens except in favor of HVB • No indebtedness except to bank with minor exceptions Events of Default: <ul style="list-style-type: none"> • Standard boilerplate • Material Adverse Change • Violation of 101.25% Collateral Value Ratio 		

o Conditions of Previous Approval not Complied with:	Deadline	Responsible Unit

Richard Pankuch

6. Decision:

☐ Approved as Requested
 ☐ Approved with Conditions
 ☐ Declined

Remarks / Conditions of the Approval Authority:

--

Date: _____

Credit Request

Delaware LLCs

January 6, 2000

1. Proposal:

HVB Structured Finance seeks approval of a plafond to fund (on a revolving basis for ten months), a series of 7 year collateralized premium loans - principal plus premium totaling USD 1.5 billion (the "Loans") plus associated swaps - to several special purpose Delaware LLCs, each of which will be a "Borrower". We will book new loans under this facility on an ongoing basis to the extent that loans are prepaid prior to year-end 2000. The number of transactions booked at any time will not exceed 10. Included in the plafond will be transactions for the principals of Presidio itself. The latter transactions will employ a slightly different structure than that used for the remainder of the plafond, but the risk analysis remains the same (see attached for differences). Note that, while we have requested an increase in dollar exposure, we have not requested an increase in the number of individual deals. Therefore, we expect no material increase in risk.

This opportunity was presented to HVB by Presidio Advisory Services ("Presidio"), a specialized advisory boutique operated by former KPMG tax partners, and focusing on high net worth individuals. It was developed in conjunction with Presidio's advisors KPMG and Shearman & Sterling and is a successor to USD 950 million in identical transactions booked in October, 1999 and successfully repaid on December 29, 1999.

The purpose of the Loans is to finance investment activities of limited liability companies organized under the laws of the state of Delaware ("Delaware LLCs"), each of which at inception is owned by an individual(s) or a trust(s). In the early stages the Loans will be secured by an investment portfolio of money market securities, investments in money market funds and/or USD and EUR or other major currencies (or other permitted investments -see below), all on deposit with, or otherwise under the control of, HVB. If the transaction runs until maturity, HVB will earn a return equal to 0.93% p.a. on the average balance of funds advanced. If the plafond is only used once and the loans are repaid on the six month anniversary of the borrowing date, DB 5 will be \$7.15 million. Given the virtual certainty that all amounts owing will be fully cash collateralized for at least 6 months, capital allocation is based on 0% risk assets, making the ROE on this transaction infinite for the first 180 days. In addition, we expect our Treasury Department to earn an additional profit of roughly 15 bps on the Stated Principal on the bid-offer spread on trades made through them by the LLCs. Earnings potential for the Treasury should exceed 0.1% on total funds advanced.

2. Transaction Summary:

Individuals/trusts will form Delaware LLCs, one for each client/group of clients wishing to use the structure. HVB will provide a 7 year, 17.8% premium Loan* to each Delaware LLC. These Loans will have an aggregate face amount of USD 937.5 million. The aggregate premium will be USD 562.5 million. HVB will advance both the Loan Face Amount and the Premium to each respective Borrower.

* A premium loan is a loan bearing an above market rate of interest. Its premium is the net present value of the difference between the loan rate and the market rate.

Credit Request
 Delaware LLC
 September 26, 1999

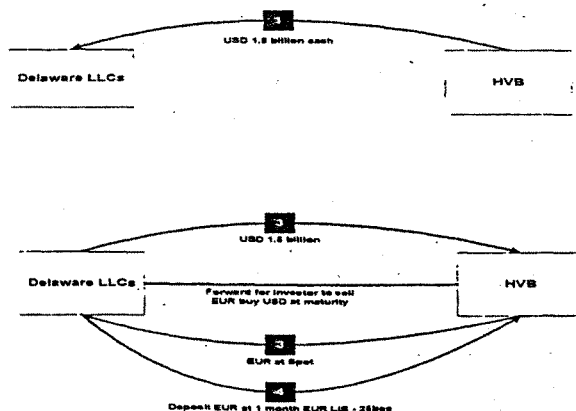
For the first several days Delaware LLCs will invest the proceeds of the Loans in money market instruments, money market funds or HVB paper or HVB deposits through HVB, one of its affiliates or other non-controlled entities acceptable to SRM Americas. No active investing activities will take place in that period of time.

At the same time, the individual(s)/ trust(s) will invest an aggregate USD 39.375 million (7% of Premium) in the respective Delaware LLCs. These investments represent the equity capital they will contribute to the leveraged investment strategies.

After each Delaware LLC is capitalized with equity and debt it will contribute its assets (cash and money market instruments/deposits), in return for a pro rata interest in the Investment LLC, to a second Investment LLC, a newly formed, single purpose Delaware company ("Investment LLC") established to carry out an investment strategy. The Investment LLC will, in turn, assume the loan made by HVB Structured Finance. Two entities related to Presidio, Presidio Growth and Presidio Resources will hold an aggregate 10% interest in each Investment LLC. Presidio Growth will manage the investment strategy.

Investment LLCs will convert the Loan proceeds plus premium of USD 1.5 billion to EUR at the spot rate and deposit them with HVB at 1 month EUR LIBOR minus 25 bps. Investment LLCs will enter forward agreements with HVB to sell EUR and buy USD 1 month forward. Each Investment LLC will open and maintain separate accounts with HVB or one of its affiliates through which all funds will flow and in or through which all collateral will be held. Investment LLCs will then use the aggregate amount of USD 1.539 billion to trade on behalf of the Investment LLC's through HVB.

In abbreviated form:



Credit Request
 Delaware LLC
 September 26, 1999

The Investment

As outlined in the Offering Memorandum, the Investment Strategy will be executed in three distinct stages over a seven-year period. Participation in the successive stages affords the investors the potential for higher levels of expected profitability with increasing levels of associated investment risk. At the end of each stage (or at any other time with notice), the investor has the option of continuing to the next stage or terminating its participation in the Fund. The investment stage commences after the Delaware LLCs have been transferred to the Investment LLCs.

Stage I – Investment cycle is 60 days with investments in relatively low risk financial instruments. Short positions in foreign currencies that are pegged to USD will be established. The investment manager intends to short HKD and ARS. There will be a cost of carry for these positions since interest rates in these two currencies are higher than USD. Investment LLCs will invest all or part of their USD borrowings from HVB in EUR at LIBOR minus 25 bps and hedge these investments back into USD.

Stage II – Investment cycle is 120 days with a similar investment strategy as that of Stage I but utilizing higher notional amounts in the short positions.

Stage III – Investment cycle is 6.5 years with higher notional amount in the short positions than Stage II and additional investments in other permitted instruments.

3. Terms and conditions of the Loans:

The Loans made to the Borrowers is proposed to be in the form of premium loans having an aggregate stated Principal Element of USD 937.5 mm and a Premium of USD 562.5 mm. The Loan interest rate is approximately 17.8% p.a. payable quarterly (specific rate to be set at closing) and the maturity is 7 years. Borrowers have options to prepay the Loans at any time subject to appropriate prepayment penalties and breakage costs. HVB will earn an Interest Rate of 17.8% p.a. plus a margin of 1.20 % p.a. on the Stated Principal payable quarterly. In addition, HVB will charge a one time custodial fee of 0.15% on the Stated Principal for maintaining accounts with the LLCs. The 1.20% margin on the Stated Principal is economically equivalent to 0.93% p.a. margin on the average outstanding balance of the total funds advanced (loan principal plus premium). If the LLCs prepay prior to the six-month anniversary of the Borrowing Date, they will pay a breakage fee of 1.20% of the Stated Principal adjusted for the days from prepayment to six-month anniversary. If the LLCs prepay any day prior to the six-month anniversary of the Borrowing Date, HVB in total will earn 7.031 mm. Below is the grid describing the benefit to the HVB under various scenarios:

Credit Request
Delaware LLC
September 26, 1999

USD	No Prepayment Year 2-7	No Prepayment Year 1	Prepaid on 6 Month Anniversary
Custodial Fee, 15 bps of Stated Principal	-	1,406,250	1,406,250
Margin, 1.2 %	11,250,000	11,250,000	5,625,000
Breakage Fee 1.2%*Principal*(180- Prepayment Days)/360	-	-	-
Total Benefit	11,250,000	12,656,250	7,031,250
Overall Return as % of average overall balance, p.a.	0.93%	1.05%	0.96%

The loan will be non-recourse to each of the individual investors. It will have recourse only to the assets of the LLCs at both stages of the transaction. The Investment Portfolio will consist of Permitted Investments (See Attachment 1).

During the life of the Investment, the entire investment portfolio will be pledged as collateral for the Loans and premium. In addition, for all of the trades, HVB Treasury will act as the trading counter-party and deposit taker.

4. Risks and Mitigants:

- HVB's collateral pools, which include all investments and/or supporting cash deposits, decrease in value.

We are protected in our documentation through a minimum overcollateralization ratio of 1.0125 to 1 at all times. Collateral values (mark to market) are reported daily by Risk Controlling and the ratio calculated by FNE. **Violation of this ratio triggers immediate acceleration under the loan agreements without notice and immediate repayment.**

The Permitted Investments (See Attachment 1) included in our agreements are either extremely conservative in nature with little exposure to interest rate risk (maximum 90 day tenor) or have no collateral value for margin purposes (interest rate swaps and options). These Permitted Investments are those contemplated by the investment manager during Phases I and II of the program. **Phase III anticipates a much more aggressive mix of investments (yet to be determined) which, however, would require our agreement to amend our loan documents to permit additional investments, which means that we would have an option to exit the transaction.**

As a practical matter, all of the risk investments will be hedged either by, or through, HVB. The Investment LLCs will enter forward agreements with HVB to sell EUR and buy USD forward to hedge its EUR deposits. HVB Treasury will assume responsibility for hedging the HKD and ARS positions into which it enters with the Investment LLCs.

- Interest rate risk associated with prepayment of the loan.

The risk arises because the investments made by the LLCs are floating rate and their loan repayment obligation is fixed rate. To hedge the interest rate basis mismatch, LLCs will enter into interest rate swaps with HVB Treasury. LLCs will receive 17.8% on USD 937.5 million notional and will pay 1 month LIBOR on USD 1.5 billion notional to HVB. On maturity date (7 years later), Investment LLCs will also pay HVB USD 562.5 million, so both coupon and principal payments are matched. (See Attachment 3) The swap is designed such that, as the

Credit Request
 Delaware LLC
 September 26, 1999

end result of all cash flows on the Loan and the swap, HVB receives LIBOR (without the margin) on USD 1.5 billion for each of the 7 years. At the end of the Loan HVB will receive USD 937.5 million Loan principal and USD 562.5 million swap settlement. If the Loan is prepaid and the swap is terminated at the same time, the algebraic sum of loan prepayment amount, swap termination payment and swap additional amount, if any, will equal the amount owing to us.

- Bankruptcy of LLCs due to a failed investment strategy/inadequate cash flow:

The likelihood of a bankruptcy for any reason other than a failed investment strategy is extremely remote. The LLCs will be single purpose companies and their activities will be limited to the investment strategies contemplated by our agreements. Debt (other than a nominal amount) other than that owing to us will be prohibited. We will have a perfected security interest in all collateral.

Furthermore, all collateral will be in possession/control of the bank.

- Disallowance of tax attributes.

A review by the IRS could potentially result in a ruling that would disallow the structure. In addition, the IRS could possibly amend provisions of the tax code and disallow benefits recognized by the structure or the tax law itself could be changed. We are confident that none of the foregoing would affect the bank or its position in any meaningful way for the following reasons:



- Operational Risks

We have established and tested procedures for working with all parties involved in the transaction. The procedures were refined through experience with the first transaction, which was successfully booked and unwound during the last three months of 1999. Departments with which we have cooperated closely include:

Credit Risk Management
 Risk Management Products
 Treasury
 HVB Capital Markets
 Cash Management
 Accounting Back Office/Treasury
 Customer Loan Servicing
 Risk Controlling
 Tax

- Due Diligence
 HVB will accumulate substantial "Know Your Customer" background information on each investor to ensure both his/her financial sophistication and that our structure is not being used for illegal purposes. Each investor will be individually reviewed, recommended and approved by SRM Americas.

Credit Request
Delaware LLC
September 26, 1999

5. References

We have established an excellent, close working relationship with all three principals of Presidio and now know them personally. They are first rate professionals, extremely competent in their areas of expertise.

6. Conclusion:

Approval to fund the Loan to the Borrowers is requested based on the following factors:

- Extremely Low Credit Risk

First, there is a security interest, in the form of low risk collateral that will protect HVB from the credit risk. The security will consist of only very highly rated instruments. In addition, the collateral will be in accounts with HVB "perfecting" our security interest. Second, the LLCs are special purpose vehicles created for this particular transaction and do not have any other meaningful creditors including the US Government that can raise claims to their assets in case of bankruptcy filing. In case, the collateral ratio of 1.0125 to 1 is violated at any time, HVB can terminate the transaction without notice.

- Extremely low regulatory capital charge and high Value at Risk Returns

Given the likelihood that all amounts owing will be fully cash collateralized, capital allocation is based on 0% risk assets, making the ROE on this transaction infinite for the first 180 days.

- Better than average returns for loans of this credit rating (2)

HVB will earn an Interest Rate of 17.8% p.a. plus a margin of 1.20% p.a. (\$ 11,250,000) on the Stated Principal payable quarterly. If the LLCs prepay prior to the sixty-day anniversary of the Borrowing Date, they will pay a breakage fee such that the return to HVB will be at least 2.84% p.a. of the average balance of funds advanced.

In addition, approval for the following FX/swap lines with the Borrowers is also requested.

1. USD interest rate swap: 7 years, HVB pays fixed on USD 937.5 mm notional and receives floating 1 month LIBOR on USD 1.5 billion notional and USD 562.5 mm at maturity.
2. Spot FX USD/EUR for USD 1.5 billion and 3 month FX Forward USD/EUR for USD 1.5 billion.
3. 3 month FX Forward (combination of USD/HKD and USD/ARS and other currencies) – net cash settle in USD for USD 1.5 billion.

Financial Engineering Department

3659

Credit Request
Delaware LLC
September 26, 1999

Financial Engineering Department

Senior Credit Risk Manager

7

HVB 003330

GB Americas	Rel/Product Mg.: <i>Deutsche</i>	CRM/ SCRM: Wolf	ZBRM: Industry/Prod./Region: Thorpe/McVey
MT:Fin. Eng.	Phone: 212-672-5727	Phone: x5399	Phone:

Amount in ☒ TEUR (Exchange Rate)

Corporate Banking Division-Credit Request dated: 4/28/00

Type of Request: ☐ New Group ☐ Review ☒ Increase/Extension ☐ Other Amendment

Approval Authority: Credit Comm.

Next Review On: ☐ Organkredit ☐ Positive Acknowledgement of Board Required ☐ Supervisory Report Required ☐ Copy to KRC9

Group:	Presidio Advisory Services		SIC:		Conforms with Credit Policy?
Industry:			Customer Since:	1999	<input checked="" type="checkbox"/> Yes
Rating:	2	(Previous)			<input type="checkbox"/> No (Justification See No. 5)
External Ratings: S&P: N/A Moody's: N/A KMV (EDF): N/A Other:					

1. Relationship Strategy:

Tendency: ☒ Increase ☐ Constant ☐ Decrease

Group Earnings				
	Gross	DB3	of that: Credit	DB5
Previous Year	4.45m	4.42m	Infinite	4.42m
Current (12/99)				
Projected *	18.75	18.7m	Infinite	18.7m
Applied for	0.5 year	0.5 year	ROEC	0.5 year

☐ Workout Credit Exposure ☐ Country Risk

Need for Loan Loss Reserve:

New **	Country Rating:
Total	Within Country Limit:
** See Risk Report	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No

* up to 30.06. current year, from 1.7. following year

Comment:

HVB Structured Finance seeks approval to increase by USD 500 mm our USD 1.5 billion approval of a plafond to fund (on a revolving basis for the remainder of the year), a series of 7 year collateralized premium loans plus associated swaps to several special purpose Delaware LLCs, each of which will be a "Borrower". The purpose of the Loans is to finance investment activities of limited liability companies organized under the laws of the state of Delaware ("Delaware LLCs"), each of which at inception is owned by an individual(s) or a trust(s).

We will book new loans under this facility on an ongoing basis to the extent that loans are prepaid. We will manage the transaction so that the number of transactions maturing at any time will not exceed 5. Each individual loan amount under the plafond will be different, and we ask that Credit Risk Management Department in New York be given authority to approve the amount of each gross exposure under the plafond up to USD 250 million. For individual amounts in excess of this amount we suggest that the Senior Risk Manager, Special Products, be given decision-making authority with notification to Messrs. Mendel and Schmittmann. Included in the plafond will be transactions for the principals of Presidio itself. The latter transactions will employ a slightly different structure than that used for the remainder of the plafond, but the risk analysis remains the same. In the early stages the Loans will be secured by an investment portfolio of money market securities, investments in money market funds and/or USD and EUR or other major currencies (or other permitted investments -see below), all on deposit with, or otherwise under the control of HVB.

If the plafond is only used once and the loans are repaid on the six month anniversary of the borrowing date, DB 5 will be \$9.34million. Given the virtual certainty that all amounts owing will be fully cash collateralized for at least 6 months, capital allocation is based on 0% risk assets, making the ROE on this transaction infinite for the first 180 days. For the remaining term of the Loans the ROE will change depending on the nature of the collateral. In addition, we expect our Treasury Department to earn a profit of roughly 15 bps on the Stated Principal on the bid-offer spread on trades made through them by the LLCs. Earnings potential for the Treasury should exceed 0.1% (USD 2 million for each time the plafond turns over).

Right now we have booked USD 688 mm in exposure (Premium plus Principal), all cash collateralized. Some of that exposure will come off the books in coming weeks. Right now there is an additional USD 695 mm in exposure is pending.

Last year we booked USD 950 million (out of USD 1.03 billion approved) in exposure (Premium plus Principal), all cash collateralized. We were repaid in full on December 29, 1999, having earned USD 4.45 million. In addition, NY Treasury earned approximately USD 1 million on its activities (FX, deposits, swaps and caps) with respect to the transaction.

The maximum number of transactions maturing at any time will be 5. The primary risks in this structure are operational, relating directly to the number of trades and associated accounting entries. Because we now have experience in all operational aspects of the structure, we believe risk to the bank will actually decrease, notwithstanding the increased dollar amount. In addition to the operational risks, there also exist documentary risks. Having been through the transaction a number of times for a number of investors we are completely confident that these risk are under control. (We will continue to use Shearman & Sterling as counsel in documentary matters.)

Again, we request that SRM Americas/SRM Special Products, as suggested above, be authorized to approve each individual investor (deal) under the Plafond.

Pursuant to our collateral formulas, the net exposure, after hedges, should never exceed our collateral. (Required collateral margin 101.25%)

2. Credit Exposure / Collateral: ☒ HypoVereinsbank AG ☒ HVB-Group Plafond (incl. approved credit lines of subs.)

	Repayment Risk incl. Guarantees, Bills of Exchg., Direct Debits	+ Replacement Risk	+ Issuer Risk*	+ (Other Risks)	Total Credit Exposure	Correction Credit Exposure	Credit Exposure (Approval Limit I)	Not Covered Risk Portion	Settlement Risk = Credit Exposure (Approval Limit II)
Limit (K) /	\$ 2 bil	\$960 m			\$2.96 bil		\$2.96 bil		\$4.75 bil
Plafonds (P)									
Thereof: New	\$0.5 bil	\$240 m			\$740 m		\$740 mil		\$1.187 bil
Thereof:			Customer Group Indebtedness (BBk): Dated:						
Tenor > 1 Year	\$2 bil	\$960 m	Total / Number of Banks: 1 Thereof: HVB						
Thereof: New	\$0.5 bil	\$240 m							
* exclude if global limits applicable					HypoVereinsbank Group Risk (Total):		\$2.96 bil		

3. Background (Counterparty / Purpose of Transaction):

Presidio Advisory Services is an investment advisory company whose founders are former KPMG tax specialists. It creates investment products, which it markets through KPMG's network to high net worth individuals. Bank loans are required to facilitate the implementation and leverage of the investment strategies. HVB has been doing business with the principals, Messrs. Pfaff and Larson, since 1997. All transactions were completed successfully.

The purpose of the facility requested here is to facilitate a specific investment strategy offered to high net worth individuals for the shorting of certain foreign currencies pegged to the USD.

4. Analysis for the Group :

Method: Rating for International Rating for Corporate Customer

a Financial Condition							
Amounts in		%		%		%	
Tot Net Sales	N/A						
EBITDA	N/A						
Net Profit	N/A						
Total Liabilities	N/A						
Total Net Worth	N/A						
Total Assets	N/A						
EBITDA / (Tot.Int.+CMLTD)	N/A						
Cash after Operations	N/A						
Cash after Cap-Exp./Investments	N/A						
Debt/EBITDA	N/A						
Debt/Capitalization	N/A						
	N/A						

Management Assessment:

Principal:	Principal :	Principal:	Contact:
John M. Larson	David Amir Makov	Robert A. Pfaff	
<p>---- From 1997 to 1999, Mr. Larson has been a Managing Director of Presidio Advisory Services, a San Francisco based investment advisory firm. From 1985 to 1997, Mr. Larson was a Senior Manager for KPMG.</p> <p>---- From 1997 to 1999, Mr. Pfaff has been a Managing Director of Presidio Advisory Services, a San Francisco based investment advisory firm. From 1985 to 1997, Mr. Pfaff was a Partner for KPMG.</p> <p>---- From 1997 to 1999, Mr. Makov has been a Managing Director of Presidio Advisory Services, a San Francisco based investment advisory firm. From 1997 to 1999, Mr. Makov was a co-founder/co-manager of a USD 150mm private investment fund. From 1996 to 1997, Mr. Makov served as Director of the Global Private Capital Group of Deutsche Morgan Grenfell. Prior to that, he was a Vice President at Merrill Lynch in the Industry Specialist Group. Prior to that, Mr. Makov was a trader and a portfolio manager at Long Term Capital Management.</p> <p>Mr. Pfaff has been known personally to FNE for 8 years. Mr. Larson has been known personally for 5 years. In 1997 and 1998 HVB concluded 5 transactions with Messrs. Pfaff and Larson. All was concluded successfully. We have the highest regard for both gentlemen.</p>			

5. Summary:

o Risks/Mitigants, Recommendation:

Risks

- HVB's collateral pools, which include all investments and/or supporting cash deposits, decrease in value.

We are protected in our documentation through a minimum overcollateralization ratio of 1.0125 to 1 at all times. Collateral values (mark to market) are reported daily by Risk Controlling and the ratio calculated by FNE. Violation of this ratio triggers immediate acceleration under the loan agreements without notice and immediate repayment.

The Permitted Investments (See Attachment 1) included in our agreements are either extremely conservative in nature with little exposure to interest rate risk (maximum 90 day tenor) or have no collateral value for margin purposes (interest rate swaps and options). These Permitted Investments are those contemplated by the investment manager during Phases I and II of the program. Phase III anticipates a much more aggressive mix of investments (yet to be determined) which, however, would require our agreement to amend our loan documents to permit additional investments, which means that we would have an option to exit the transaction. Any changes would have to be approved by SRM Americas and SRM Special Products.

As a practical matter, all of the risk investments will be hedged either by, or through, HVB. The Investment LLCs will enter forward agreements with HVB to sell EUR and buy USD forward to hedge its EUR deposits. HVB Treasury will assume responsibility for hedging the HKD, ARS and potential other forward positions into which it enters with the Investment LLCs.

- Interest rate risk associated with prepayment of the loan.

The risk arises because the investments made by the LLCs are floating rate and their loan repayment obligation is fixed rate. To hedge the interest rate basis mismatch, LLCs will enter into interest rate swaps with HVB Risk Management Products. LLCs will receive 17.8% on USD 1.25 billion notional and will pay 1 month LIBOR on USD 2 billion notional to HVB. On maturity date (7 years later), Investment LLCs will also pay HVB USD 750 million, so both coupon and principal payments are matched. The swap is designed such that, as the end result of all cash flows on the loan and the swap, HVB receives LIBOR (without the margin) on USD 2 billion for each of the 7 years. If the loan is prepaid and the swap is terminated at the same time, the algebraic sum of loan prepayment amount, swap termination payment and swap additional amount, if any, will equal the amount owing to us.

- Bankruptcy of LLCs due to a failed investment strategy/inadequate cash flow.

The likelihood of a bankruptcy for any reason other than a failed investment strategy is extremely remote. The LLCs will be single purpose companies and their activities will be limited to the investment strategies contemplated by our agreements. Debt (other than a nominal amount) other than that owing to us will be prohibited. We will have a perfected security interest in all collateral. Furthermore, all collateral will be in possession/control of the bank.

- Disallowance of tax attributes.

A review by the IRS could potentially result in a ruling that would disallow the structure. In addition, the IRS could possibly amend provisions of the tax code and disallow benefits recognized by the structure or the tax law itself could be changed. We are confident that none of the foregoing would affect the bank or its position in any meaningful way for the following reasons:

- Operational Risks

We have established and tested procedures for working with all parties involved in the transaction. The procedures were refined through experience with the first series of transactions, which was successfully booked and unwound during the last three months of 1999. Departments with which we have cooperated closely include:

Credit Risk Management	Cash Management	Risk Management Products
Treasury	Tax	Risk Controlling
HVB Capital Markets	Customer Loan Servicing	Accounting Back Office/Treasury

- Due Diligence

HVB will accumulate substantial "Know Your Customer" background information on each investor to ensure both his/her financial sophistication and that our structure is not being used for illegal purposes. Each investor will be individually reviewed, recommended and approved by SRM Americas.

References

We have established an excellent, close working relationship with all three principals of Presidio and now know them personally. They are first rate professionals, extremely competent in their areas of expertise.

Credit References

We contacted Deutsche Bank, which has closed approximately seven billion dollars of transactions similar to the one presented here. In September, 1999, the Deutsche Bank representative stated that they had been doing business with Presidio for approximately three years and had closed approximately USD 7 billion in transactions up to that point. Their experience has been excellent and they have the highest regard for Presidio's principals.

Recommendation

In view of extremely low risk and high profit potential of this transaction and those to follow we recommend approval.

3663

o Covenants/Other Conditions:		Deadline	Responsible Unit
Covenants: <ul style="list-style-type: none">• No consolidation; merger; sale of assets except pursuant to our agreements• No liens except in favor of HVB• No indebtedness except to bank with minor exceptions Events of Default: <ul style="list-style-type: none">• Standard boilerplate• Material Adverse Change• Violation of 101.25% Collateral Value Ratio			

o Conditions of Previous Approval not Complied with:		Deadline	Responsible Unit

Richard Pankuch

6. Decision:

☐ Approved as Requested ☐ Approved with Conditions ☐ Declined

Remarks / Conditions of the Approval Authority:

Date:

Structural Differences in the Transaction for Presidio Principals

The transaction for the Presidio principals is slightly different than outlined in the credit request. However, the risks (financial/collateral monitoring, operational) remain virtually identical. The significant differences are:

1. HVB will make a loan to each of the initial Delaware LLCs, rather than a joint and several loan, as is the case with the conventional multi-borrower structure.
2. Ownership in the Delaware LLCs will be transferred to the Investment LLC rather than assets and liabilities being transferred in exchange for an ownership interest.
3. Presidio Growth and Presidio Resources will not be involved as investors but Presidio Growth will act as investment advisor.
4. The individual LLCs will enter into the respective hedges and swaps with HVB.

3665

Francesco Piovanello

To: NANCY DONOHUE

cc:

Subject: presidio - w. revisions, i will call u in 1 min

Sent: 04/28/1999 12:58 PM

CLIENT

Presidio is the tax and capital markets marketing arm of KPMG. There are 3 main partners at Presidio

Bob Pfaff
John Larson
Amir Makov

Bob and John built their careers at KPMG as tax attorneys and members of the 6,000 person tax accounting group. Amir was recently at Sentinel, where he worked on the Doe Equis trades with DB. The Doe Equis trades, after all expenses, generated about \$10 - 15 mm usd in fees to DB in 1998.

Amir left Sentinel and Arl Bergman to join Presidio in early 1999. Amir's original connection to Presidio was made through David Kelley and Roberto Marsella.

Presidio is a well known client to DB in the Private Bank, Special Products Group and the Equity Derivatives Group (Frankfurt). Last year, through the OPIS program, which involved a large program of equity derivative trades, OPIS generated fees to DB in the excess of \$35 mm, and net of expenses the number was approx \$33 mm.

Presidio, in conjunction with ICA, have developed a new product called BLIPS. BLIPS will be marketed to client end users through KPMG mainly by John Larson. Amir Makov will take responsibility for executing and managing the capital market transactions for BLIPS.

BLIPS TRANSACTION

BLIPS will be marketed to High Net Worth Individual Clients of KPMG.

It is envisioned that BLIPS will be a large program, covering over a 6 month period of time over 40 separate accounts / counterparties.

Loan Balances over time could be as large as \$5 billion in par amounts + \$3 bn in premium. Fees to DB are estimated to be in the 1.25% of premium range (30+ mm usd).

The BLIPS program will involve the following:

1- HNW Individuals will be introduced to the DB Private Bank by Presidio for Know Your Client and Suitability Review.

2- The HNW Individual will receive a loan from the DB Private Bank. The Loan will be a high coupon loan (16%) and the loan amount will be delivered to the HNW Individual in the form of a par amount (100) and a premium amount (estimated at 60). The loan amount will be priced by Global Markets off the US Interest Rate Swap Curve.

For tax and accounting purposes the Loan Liability for the HNW Individual will be the par amount only (100), not the premium.

The Loan Proceeds (Par + Premium) will be held in custody in a DB Global Markets Margin Account.

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 240

3- After a 7 to 10 day holding period, the HNW Individual will transfer all Loan Proceeds to an LLC. The LLC will also have 3% of par amount Equity Capital contributed by the HNW Individual and an additional 10% of 3% Equity Capital contributed by the Manager of the LLC, Presidio. (so, in the example here the LLC will have 100 Par amount + 60 mm Premium + 3 mm HNW Equity Capital + .3 mm Presidio Equity Capital for a total of 163.3 mm usd). The entire amount of funds in the LLC will be held in custody at a DB Global Markets Margin Account.

4- The LLC will enter into an Interest Rate Swap to convert its Loan Liability from Fixed into Floating.

5- The LLC will enter into a series of FX transactions, all approved by DB and all executed by DB. Typical trades will be in the 2 month forward FX market, Long USD/Short HKD, Long Argy Peso / Short USD, Long Euro / Short DKK.

6- The LLC's trades will typically have negative carry and will be designed to make \$ for the LLC in the event of a global markets crisis. In addition there will be negative carry for the LLC on the Loan interest that it owes vs the interest on the funds that it holds in the Global Markets Custody Account.

7- The appropriate amount of Equity Capital in the LLC will need to be determined by Global Markets Credit and it will have to cover the negative carry of the LLC and accommodate for any adverse market movements.

8- The holding period / life of the LLC will typically be 45 to 60 days. At the end of this time period, the LLC will unwind all transactions, repay the loan par amount and premium amount. For tax and accounting purposes, repaying the premium amount will "count" like a loss for tax and accounting purposes.

WHO IS INVOLVED SO FAR AT DB

The following people have been working on the transaction

Private Bank John Rolles, Presidio Relationship Mgr
Doug Lemmonds, Credit

Global Markets Francesco Piovaretti, structured products
Nancy Donohue, global market sales
Steve Cohen, structured product credit

Tax Joe Cassidy, DB NA Tax

Legal Michelle Cenis, DB
Alvin Knott, Shearman & Sterling
Gerry Rokoff, Shearman & Sterling

nb: Shearman & Sterling worked with DB on OPIS and Doe Equis transactions.

PRESENT CONCERNS

The Regulatory and Bankruptcy Implications of having a High Coupon / Off Market Loan

The Regulatory Implications of having what looks like an Equity Stake/ Control of the LLC b/c of the high coupon loan

Getting Top Level Global Markets Go Ahead to proceed

DIVISION OF RESPONSIBILITY / FEES ETC

John Rolles in Private Banking is presently the RM for Presidio.
Private Banking will be responsible for

Know Your Client and Suitability Review for all HNW Names
Sourcing from Treasury the Loan proceeds
Bearing the Capital Hit for making the Loans

Nancy Donohue/Francesco Piovanello can act as the RM for Presidio. Global Markets will be responsible for:

Setting up ISDAs for 40 accounts
Setting up Margin Accounts for 40 accounts
Pricing the Loan on the US Swap Curve
Executing and Settling the Interest Rate Swap and FX Trades
Monitoring, Daily, the value of the LLCs vs Equity Balances

Fees: Typical fee splits between Private Banking and Global
Markets/Structured products have been: 30% to Private Banking and 70%
to Global Markets/Structured Products, after accounting for all fees
(legal etc) and risk reserve set asides.

3668



Francesco Piovaneli

To: Ivor Dunbar/DMGSF/DMG UK/DeuBa@DMG UK

cc:

Subject: "Hugo" BLIPS Paper

Sent: 07/01/1999 05:59
PM

Ivor,

Let me know if this is sufficient:



hugopaper.doc

I am setting up a conf. call tomorrow morning with Nancy Donohue, David Thomas, and Michael Dougherty to discuss the controlling (rwa) aspects of the trades.

Best regards,

FP

DB BLIPS 6885

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 244

Bond Linked Indexed Premium Strategy "BLIPS"

BLIPS will be marketed to High Net Worth Individual Clients of KPMG by Presidio Advisors. Presidio has structured a foreign exchange investment program with significant pre-tax profit potential for investors.

Presidio has approached DB for the execution and financing of the BLIPS program.


It is envisioned that BLIPS will be a large program, covering over a 6 month period of time over 40 separate accounts / counterparties.

Loan Balances over time could be as large as \$5 billion in par amounts + \$3 billion in premium. Fees to DB are estimated to be in the 1.25% of premium range (\$30+ mm usd).

DB's involvement will be the following:

1. Presidio will approach DB with a US Individual that is interested in investing in the BLIPS program.
2. US Individual will establish a newly created special purpose vehicle (Delaware LLC) to invest in the BLIPS program.
3. DB Private Bank will perform a Know Your Client Review regarding the US Individual.
4. LLC will receive a nominal seven-year loan from DB Global Markets. The loan will be a high coupon loan (16%) and the loan amount will be delivered to the US Individual in the form of a par amount (\$100 mm) and a premium amount (estimated at \$60 mm). The loan/premium amounts will be priced by Global Markets off the US Interest Rate Swap Curve. US Individual will cash collateralize the loan with approximately 7% of the premium amount (\$4.2 mm).
5. For tax and accounting purposes the loan liability for the LLC/US Individual will be the par amount only (\$100 mm), not the premium (\$60 mm). The loan proceeds (par and premium) will be held in custody at DB in cash or money market deposits. Loan will include a prepayment clause with provisions to require repayment of unamortized premium in addition to principal. Loan conditions will be such as to enable DB to, in effect, force prepayment after sixty days at its option.
6. After a seven to ten day holding period, the LLC will transfer all loan proceeds to a newly established multi-member LLC ("Multi-LLC"). The Multi-LLC will also have an extra collateralization of 0.7% of the premium amount (\$420,000) contributed by the manager of the Multi-LLC, Presidio (in our example the Multi-LLC will have \$100 mm par amount, plus \$60 mm premium, plus \$4.2 mm US Individual equity capital, plus \$420,000 mm Presidio equity capital for a total of \$164.42 mm). The entire amount of funds in the Multi-LLC will be held in custody at a DB Global Markets Margin Account.
7. Global Markets Structured Transactions Group and Relative Value Group will handle the daily (real-time) monitoring of the collateral. Presidio will act as the Investment Adviser to the Multi-LLC. DB will execute the BLIPS strategy that Presidio will be managing for the US Individual.

3670



David K Thomas-Control

To: Paul Glover@Bankers_Trust, William Boyle@Bankers_Trust, Brian J
McGuire@Bankers_Trust, Michael Dougherty@Bankers_Trust,
David Hugo@Bankers_Trust

Sent: 07/19/1999 05:31 AM

cc:

Subject: Update NY Issues

Paul/David,

Have there been any further thoughts on the US ACT Prefs provision. I thought we were trying to get this written back to P+L.

Paul/Bill

What is the status of the BLIPS. Are you still actively marketing this product. I understand that tax in Frankfurt may have problems

Can I have a copy of the FASIT model for P+L. I want to keep a copy of all P+L models

Bill/Brian,

Are we going to be able to recognise CARD in July. Can you provide details

Brian,

What should I expect as the timetable for the Project Cochise P+L on the release of REMIC receivable P+L.

Sorry for all the questions but we need to get a lot of MIS together

Rgds

David

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 256

DB BLIPS 6775

Update on the Private Exchange Fund

We wanted to give you an update on the status of the "Private Exchange Fund" ("PEF"). As you know this was a strategy originally developed at Bankers Trust that offered many of the advantages of the exchange funds which we have offered our clients in the past, and are still marketed by some of our competitors (Eaton Vance, Goldman, Bessemer Trust etc.).

The PEF is a privately negotiated product involving a partnership or limited liability company in which only Deutsche Bank and the client is involved (as opposed to the hundreds of investors in the public funds). It allows the client to diversify out of a single stock position, retain a significant degree of control in how the assets are allocated and managed, and offers some unique tax benefits.

Since the merger of Bankers Trust and Deutsche Bank the Structured Transactions Group in the Fixed Income Division, the sponsors of the product, have made some structural changes to the product. They have also obtained the necessary approvals to market the product. Transactions would still need to be approved on a case by case basis.

However, many of the details still remain unresolved. For example, we are still working on refining the template partnership documents, developing the investments advisory agreement, and we have not obtained a final tax opinion from our legal advisors. In other words, the product has not been "packaged" sufficiently in our view so as to offer a client quick, turnkey execution. We may not yet be in a position to deliver the product with the kind of certainty we would have on a standard collar or varying forward transaction.

There has been legislation introduced in Congress which would eliminate the viability of the public funds, which may also impact our PEF product. Since the current language of the Neal bill is extremely broad, we do not expect it to be the final language of any enacted legislation. The bottom line is that there is some risk that legislation would kill the product. Moreover we have no authority as to whether transactions in place would be "grandfathered", or what the effective date might be - retroactively, December 231st, 1999, or some date in the future.

Quite aside from the current proposed legislation, the PEF is subject to any adverse tax legislation being enacted over the 7 years following the inception of the transaction.

The PEF involves the partnership or LLC typically monetizing its position through a collar and loan or a variable delivery forward contract. Since the tax benefits of the structure do not materialize until Deutsche exits from the partnership at the end of 7 years, you need to consider the probability of any hedge remaining in place for that period. A cash merger involving the stock, or Deutsche's inability to maintain its hedge, might be two reasons for the client being unable to realize the full tax benefits of the PEF.

In view of the complexity of the product, as well as the legal and market contingencies outlined above, IRs need to be extremely cautious in screening potential candidates for this strategy. The criteria should be:

- ☐ Minimum transaction is \$25 million
- ☐ The client should be sophisticated and be represented by legal and tax advisors versed in complex financial transactions
- ☐ The stock in question be a very liquid name

Please screen any potential candidates with us before the product is discussed with the client. We will keep you updated on any developments.

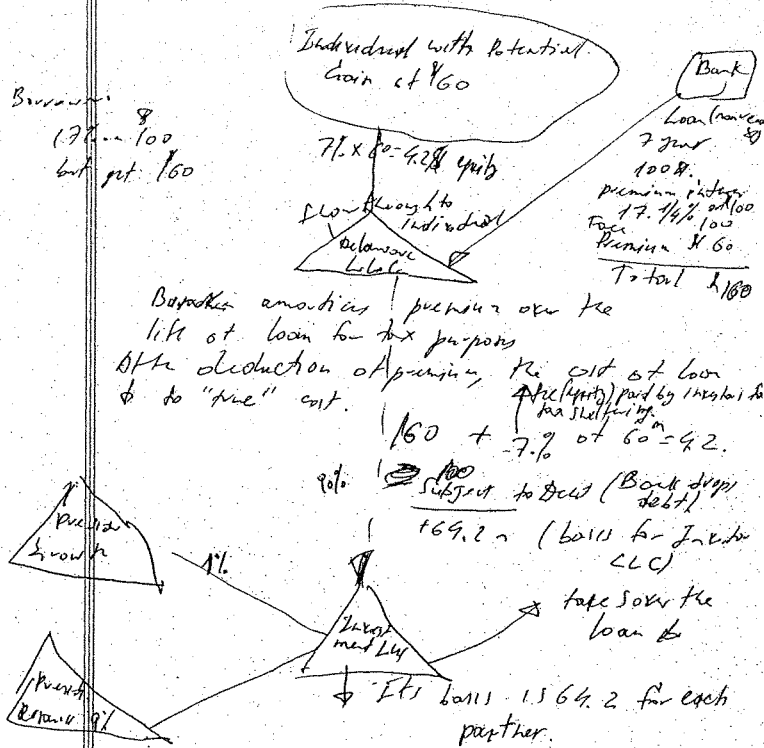
DB BLIPS 6433
DB BLIPS 6434

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 257

Presidio

- Private Individuals - more receptive & easier
Distribute through KPMG



Colateral: \$164.2 at start and per currency
at (Investment LLC level)

Investor LLC swaps to counter the interest rate risk at 160. If rates ↑, value of swap ↓.

Premium
Reserve $\rightarrow 500 \text{ th.}$
 $\frac{-4.2}{4.9 \text{ at risk.}}$

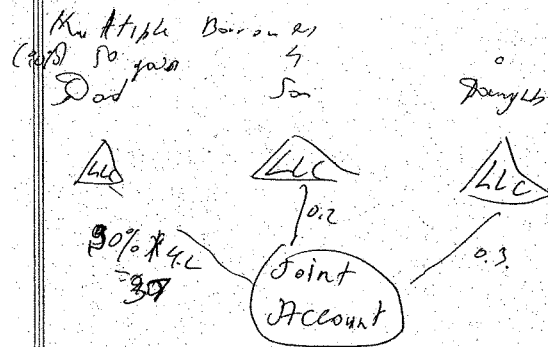
- kpmg 12T bps x premium. (for 60 days)
 - DB 12T bps x premium.

Low Firm,
 SDS - DP

164.2 collateral in currency
 160 is pledged. 4.2 is not.

- Phase 1 - 60 days. Most leave for tax purposes.

X Investor LLC generates loss & allocates it to its investors
 Delaware gives them 164.2 liability to 100
 Investor LLC owes 100 to bank & has 64.2 eq. investment from Delaware.
 So Delaware has 112 Investor - 154.2
 Delaware says - liquidate Investor & pay bank 164.2 & Investor has "0" but Delaware has 154.2



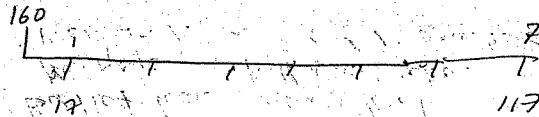
- ① Currency Risk Hedged.
- ② Sued by the Investors? - Release.

160 mm.
 at $17\frac{1}{4}\%$
 100% + 8%
 So additional $(17\frac{1}{4} - 8)$, if present
 needed, is 60%.

Borrower amortizes the premium
 paying the cost & deduction down to true
 cost. So off sets the interest payable
 & derived the sliced & from $17\frac{1}{4}$ ~~17~~ (T) &
 true ~~8%~~ 8% (T) (sliced)
 Prepay the loan & then pay back the premium.
 (subject to interest fluctuations)

100 free at $17\frac{1}{4}\%$
 Int @ 12,250,000
 - Premium Amort. $60/7 = 8\frac{1}{2}\%$
 Net True Borrowing Rate

Business Purpose of Investor LLC
 - Bank Loan is non recourse to individual.



Principal = 100 Premium = 60
 Business Purpose of premium loan

HVB 000207

20-2 = 1.8% to

50 mm. \ 60% prem 1.7 1/2%

• Old Fik - similar deal.

2-4 pages.

- Cash Collateral

- 7 year deal but

"redemption" provisions

- Premium Bond - why?

- More on the interest rate risk

It's coupon get paid less sensitive to interest volatility

Bullet is "ignoring" volatility

Montpierre loan is really convex. Volatility

is pretty good start since no principal at end

- Write-up → Ewerton LLC.

- Deleone to Inverto LLC

Drop but not too coupon

- Convexity - Premium bond

- Non-recourse Loan

- Collateral.

- Structure of the Collateral -

puts & stuff

HVB 000210

* Premium is less "relative" to interest rate risk

since there is some payment at end (had)

Bullet is more "equivalent" since end payment

= 1st payment.

• Match convexity of the loan &

Investment, Inverto int. as leverage low



Investment ↑ gradually & more interest rate sensitive

Duration of LTAs & DTAs

• Repay the loan in 60-120 days
 I don't know precisely like additional capital infusion required

To: Christopher Thorpe
Rolf Quaas
Ted Wolf

From: Dom DeGiorgio/Richard G. Pankuch

Date: August 16, 2000

Re: Presidio BLIPS Transactions

Following is a status report on our current transactions. In addition, we have attached to this memo the following:

A memo from our legal counsel summarizing the Treasury Notice and its implications for investors, promoters and HVB

The text of the Treasury Notice

A list of outstanding loans

To summarize, it is clear that tax benefits for individuals who have participated in the transaction will not be grandfathered because Treasury believes that their actions were contrary to current law (a matter which will obviously be litigated if Treasury attempts to deny deductions to past users rather than simply prevent future deals).

It is not likely that KPMG/Presidio will go forward with additional transactions, notwithstanding the fact that the Treasury notice does not mean that the structure can be challenged successfully. We do not yet know what will happen to the existing deals on our books. Some may be prepaid; others may not. We should know more by the beginning of next week.

As we have stated previously, we anticipate no adverse consequences for the HVB since we have not promoted the transaction. We have simply been a lender and nothing in the notice implies a threat to our position.

In view of the tone of the notice we will not book any new transactions and will cancel our existing unused lines prior to the end of this month.

We will keep you informed of further developments.





Claudia.Schliwa@Vereinsbank.de on 10/13/99 09:25:09 AM

To: Richard Pankuch/Hypo/NY/NA/Vereinsbank
cc: Erwin.Voit@Vereinsbank.de
Subject: KWG I capital treatment for Presidio Transaction

Dear Mr. Pankuch,

Referring to your e-mail regarding KWG I treatment for your Presidio Transaction:

In order to achieve a zero-weighting,

* there must be a collateral uninterrupted with the same maturity as the loan

(If the definitive maturity of the collateral is not certain from the beginning, it does not meet the requirements).

* The exchange of the collateral (deposit or other types of security) during the maturity does not alter the weighting.

Should you need a check of the contract, please contact Dr. Früh, RET6.

KRCSEK
Erwin Voit

Claudia Schliwa

OK

There is not a maturity

*Phone call w/ Voit
10/13/99*

*Confirmed "0" weighting
because collateral
cannot be withdrawn
before loan
matures!*

RZP

*Bill Tsai
present.*

3680



Richard Pankuch
10/12/99 11:41 AM

To: Erwin.Voit@Vereinsbank.de
cc:
Subject: KWG I capital treatment for our Presidio Transaction

Mr. Voit:

Referring to my recent e-mail regarding KWG I treatment for our cash collateralized transaction and your conversations with my colleague, Bill Tsai:

- I understand that you think we should have a short reconfirmation of the pledge of the deposit at each maturity if we seek "O" capital weighting. I believe that your opinion results from our not having been clear enough about our specific structure:

Our structure calls for all collateral to be placed in a collateral account pledged to the bank. This collateral could consist of deposits and other types of security. The Pledge and Security Agreement that gives the bank a security interest in the collateral under US law includes specific language which, in our opinion, should eliminate the need for these reconfirmations. Specifically:

The agreement covers "... all cash ... held in or credited to the Collateral accounts ... and all dividends, interest, cash, instruments, investment property and other property from time to time received, receivable or otherwise distributed in respect of or in exchange for, or in substitution for either Collateral Account or any or all of such cash, security entitlements, financial assets, investment property and other property; (Italics mine)

In other words, the documents already secure rollovers and replacement of collateral, thus eliminating the need to continuously reconfirm the pledge of the deposits in order to achieve "O" capital weighting. Note: "cash" includes deposits under US law.

I would appreciate your letting me know immediately if you agree with our analysis since our closing is scheduled for later this week.

Thank you in advance.

Dick Pankuch

HVB 000352

3681

Redacted by the
Permanent Subcommittee
on Investigations

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 266

HVB 000147-154

SEP-27-1999 MON 07:26 PM HYPOVEREINSBANK

FAX NO. 2126725591

05:11 66. 00 235

P. 10

Credit Review
Delaware LLC
September 26, 1999

Borrowing Date, HVB in total will earn USD 250,000. Below is the grid describing the benefit to the HVB under various scenarios:

	No Prepayment Year 2-7	No Prepayment Year 1	Prepaid on 60th day
Custodial Fee, 15 bps of Stated Principal	\$ -	50,000	50,000
Margin, 1.2 %	400,000	400,000	65,667
Breakage Fee 1.2%*Principal*(180- Prepayment Days)/360	\$ -	\$ -	133,333
Total Benefit	400,000	450,000	250,000
Overall Return as % of average overall balance, p.a.	0.93%	1.05%	2.84%

The loan will be non-recourse to each of the individual investors. It will have recourse only to the assets of the LLCs. HVB will have a perfected security interest on all collateral. The Investment Portfolio will consist of Permitted Investments (See Attachment 1).

4. Tax attributes to the Investors:

Investors have represented that they expect to profit from their investment in the Investment Fund and can enhance profit potential by leveraging their investments, hence the Loans from HVB. For reasons described above, namely to match investment risk with financing risk, the Loans have been structured as "Premium" loans. The nature of these loans can also result in certain tax attributes to the investors. At the time the individual trusts assign the LLCs (along with the Loan proceeds and equity contribution) to HSMI, a cost basis (for U.S. tax purposes) in HSMI is established.

In the event the Investments do not generate a significant return, the Investors might elect to terminate their investments and liquidate the LLCs. Upon liquidation of the LLCs, a capital loss for U.S. federal income tax purposes is generated. This deduction can be used to offset other capital gains of the investors.

5. Risk Assessment:

- HVB's collateral pools, which include all investments and/or supporting cash deposits, decrease in value.

We are protected in our documentation through a minimum overcollateralization ratio of 1.0125 to 1 at all times. Violation of this ratio triggers immediate acceleration under the loan agreements without notice.

The Permitted Investments (See Attachment 1) included in our agreements are either extremely conservative in nature with little exposure to interest rate risk (maximum 90 day tenor) or have no collateral value for margin purposes (interest rate swaps and options). These Permitted Investments are those contemplated by the investment manager during Phases I and II of the program. Phase III anticipates a much more aggressive mix of investments (yet to be determined) which, however, would require our agreement to amend our loan documents to permit additional investments, which means that we would have an option to exit the transaction.

HVB 000155

5.9 NR.758

HYPOVEREINSBANK SRM SPECIAL PROD

30-SEP-1999 16:47

3683

Redacted by the
Permanent Subcommittee
on Investigations

HVB 000156-164

Deutsche Bank @

MEMORANDUM

Structured Transactions Group

To Mick Wood

cc Ivor Dunbar, Stuart Bray, Paul Glover, Francesco Piovanetti

From William Boyle

Subject GCI Risk and Resources Committee - BLIPS Transaction

Date July 29, 1999

The GCI Structured Transactions Group has been approached by Presidio Advisors *Suggest a few lines somewhere on who Presidio are. with the opportunity to lend money to, and execute foreign currency and interest rate transactions on behalf of are you dealing "on behalf of", or "with", a U.S. limited liability company are the fx deals with the same LLC to whom we lend, or it is the sub LLC which is implementing the Bond Linked Indexed Premium Strategy (the "BLIPS Strategy").* The BLIPS Strategy will be marketed as a foreign exchange investment program to high net worth individual clients of KPMG by Presidio Advisors. The BLIPS Strategy involves taking short positions in certain foreign currencies pegged to the U.S. dollar (e.g. Hong Kong dollar and Argentina Peso) and a long position in U.S. dollars. *You should be ready to address the question as to how you deal with the negative carry that this strategy implies.* Deutsche Bank ("DB") will not market the transaction nor provide any tax or investment advice to the participants in the transaction. DB will obtain representation letters from Presidio Advisors, KPMG and the Individual Investor which document DB's role as a lender and market maker of foreign currency and interest rate transactions and not as a marketer of the BLIPS strategy or a provider of tax or investment advice regarding implementation of the BLIPS Strategy.

Transaction Structure - DB will have the opportunity to lend, on average, \$160 million to each of approximately 25 limited liability companies (the "Investor LLC's") on a non-recourse basis / *don't think you mean "non-recourse" I think you mean "limited recourse". (see below).* The loans will take the form of seven year fixed high coupon yielding \$100 million notes (the "Notes") *Do you mean that we don't actually make a loan, but buy notes at a premium? If so you need to be ready to address the accounting implications for us* The Investor LLCs will be owned by U.S. individuals *who presumably inject the capital of around US\$5mm see below.*

After a period of seven to ten days, the Investor LLCs are expected to contribute *what form does this contribution take? This is the linked to how the benefits of the investment strategy get passed back upstream to the Investor LLC, and thus to the equity value of the Investor* approximately \$165 million, *(I.e the proceeds of the [loan/note purchase] by DB and the capital injection) [subject to the Note], to a (single?) second LLC (the "Investment LLC") which will execute the BLIPS Strategy(for all Investor LLCs).* Presidio Advisors, who will manage and advise on the BLIPS Strategy, will contribute approximately \$500,000 to the Investment LLC in exchange for an equity interest in Investment LLC. DB will enter into a separate swap transaction *presumably with the Investor LLC which has the effect of converting the cash flow obligations of the Investor LLC under the Note into the cash flows equivalent of a \$160 million Libor based loan.* DB expects to *(why is there a question about this?)* enter into the swap with the Investor LLC. *Similar to the Note(First mention of this?), an assignment and assumption of the swap will be entered into by the Investment LLC(you need to clarify what this*

means; presumably that all obligations to DB of the various Investor LLCs including under each note and swap, will be assumed by the Investment LLC. Between the Note and the swap, DB will receive repayment of the \$160 million advanced to the LLC. Again you need to be ready to talk in terms of credit exposure and book value of the combination. The entire amounts contributed to the second LLC will overcollateralize the Note (first mention of collateral – you probably need to mention that all assets of the Investment LLC will be held by DB and pledged to DB to secure its obligations, also that the Investment LLC will incur no other obligations (except tax etc) other than to DB – this is relevant in view of the synthetic short strategy to be adopted).

Should the collateral value of the assets to the obligations due fall below 1.0125:1.0, DB may immediately liquidate the collateral and apply the proceeds to repay amounts due under the Note and the swap. Based upon the type of investments permitted under the credit agreement and the period the loan is expected to be outstanding, the LLC should meet the collateral value ratio test. Please, review attached RVG discussion regarding the adequacy of the collateral. *You should mention whether DB has any right to restrict/control investments (I would expect not if we are to distance ourselves from management). More important, you need to be ready to address how the "collateral" will be valued, and its liquidity, particularly bearing in mind the size of positions and the very slim threshold.*

Benefits of the Transaction - The Note has a seven year term. If the Note remains outstanding for the entire term, DB will earn Libor plus 75 bps annually on a fully collateralized basis. Should the Individual choose to exit the BLIPS Strategy at any time during the first six months, DB will earn Libor for the period the loan is outstanding plus an amount equal to 37.5 bps of loan proceeds advanced. In addition, DB will receive a custody fee equal to 9.375 bps (*per annum?*) of the loan proceeds advanced.

Review of BLIPS Transaction - In structuring DB's potential involvement in the BLIPS transactions, the Structured Transactions Group has worked very closely with the following groups: Relative Value, Private Banking, Tax, Legal, Credit, Compliance, and our outside legal advisor Shearman & Sterling.

Tax – The tax department has closely reviewed our anticipated involvement in the transactions and the tax opinions we **expect to receive** (*expect questions on why you say "expect to receive" – also be aware you will get no clean sign off from RRC without a clean opinion – expect us to define who has to satisfy themselves as to how clean is clean*) from Shearman & Sterling and believes that the tax reputational risk to DB should not preclude DB's involvement in the transactions. The tax department believes that DB should not experience any negative tax implications from our involvement in the transactions and that any tax reputational risk can be managed properly by the Structured Transactions Group. *This is wooly!* Their conclusion is supported by the limited number of transactions, the involvement of DB in the transaction in their ordinary role as a lender and market maker of foreign currency and interest rate transactions, the marketing role of Presidio and KPMG, and the tax advice provided by KPMG and Brown & Wood to the Individuals.

The tax reputation risk will be cleared with the Americas CEO ***This is a strong plus point – (John Ross's views are certainly respected by me at least)*** prior to execution of the first transaction.

Credit – The Structured Transactions Group has worked closely with the NY credit department and Shearman & Sterling to ensure that the payment of interest and principal to DB is secured. The LLC will be overcollateralized and should the value of the collateral drop below a 1.0125:1.0 ratio, DB may liquidate the collateral immediately and apply the proceeds to repay amounts due under the Note and swap agreements. The Structured Transactions Group and the Relative Value Group will work with Credit Risk Management to closely monitor the value of the collateral assets to ensure that DB's principal and accrued interest is protected. *In view of the thin cover, this should be shown to be full real time cover, including intraday and holiday cover. Presumably New York Exposure Management Team in CRM is closely involved.*

Legal – The Structured Transactions Group has worked very closely with Michelle Cenis of the Legal Department and Shearman & Sterling in structuring and drafting the Credit Agreement and related legal documents. Subject to reviewing the final documents, the legal department is expected to sign-off.

Risk Weighted Assets – Based upon discussions with David Hogarth, of Product Controllers, and David Thomas regarding the current structure, we expect to receive a zero risk weighted asset allocation to the transaction.

Compliance – Based upon discussions with Mary Owens and receiving the appropriate sign-offs from the tax, credit and legal departments, compliance will sign-off on the transaction.

Private Bank – The Private Bank will provide the white gloves review of the Individuals and open accounts on behalf of the LLC. Based upon the Structured Transactions Group receiving the appropriate sign-offs, the Private Bank is comfortable participating in the transaction. Who runs risk? Who gets profit

New Products Committee - Dr. Alfred (Ted) Dengler, Chair of the New York New Products Committee, has been consulted about the transaction. Consistent with the Vorstand product approval guidelines for Structured Transactions Group transactions, Dr. Dengler has concluded that it is not necessary for the BLIPS program to undergo New Products Committee review.

Risk and Resources Committee Sign-off - Based upon the potential number and size of lending transactions, we request the GCI Risk and Resources Committee to provide clear authorization to Harry Olsen that he may provide credit approval to the aforementioned LLC's owned by U.S. Individuals solely upon the credit quality of the transaction.

STG will notify the Tax department of each new transaction prior to execution and the Tax department, together with STG, will assume responsibility for monitoring material changes in the reputation risk associated with these deals and will bring such changes, if any, to the attention of senior management.

Note to BLIPS development team – Most of you have seen sections II through V of this document previously in a slightly different version. I have modified these sections somewhat to conform to our current expectations regarding the deal structure.

Section I is new. It has been added to summarize my understanding of the action steps that remain before we can start closing deals. For this purpose I am assuming that we have a complete signoff on the tax side from KPMG and Brown & Wood. Each of you should feel free to add to or markup this draft as needed.

BLIPS – transaction description and checklist

I. Checklist – action steps remaining

By Deutsche Bank/Shearman & Sterling

- Complete internal due diligence including review by new product committee, signoff by credit, tax signoff by internal General Counsel/Shearman & Sterling, other (?)
- Determine whether DB will be able to participate in sales solicitation. (tax shelter registration issue)
- Confirm how loan premium will be recorded on Bank balance sheet. (KPMG should have previously advised on this issue.)
- Deutsche Bank/Shearman & Sterling – complete model credit documentation: loan to LLC (assignable to Partnership) and pledge agreements.
- Deutsche Bank/Shearman & Sterling/Presidio – complete model fixed to floating swap agreement.
- Deutsche Bank/Presidio – agree on permissible FX trading policy for Partnerships.
- Deutsche Bank/KPMG/Brown & Wood – agree on model approach for aggregation of small groups of investors. (Refer to the hub and spoke structures used in the OPIS trades.)
- Advise on KYC issues and procedures for these trades.

Presidio

- Have Presidio's attorneys (Shartsis, Friese & Ginsburg – San Francisco) prepare model partnership agreement for use by Partnerships.
- Have Presidio's attorneys (or Shearman & Sterling?) prepare model LLC agreement.
- Advise DB on proposed trading strategies and perceived risks.

II. Assumed Facts

3/4/1999

1

Proprietary Material
Confidentiality Requested

KPMG 0003933

Permanent Subcommittee on Investigations EXHIBIT #155 - FN 268
--

1. Investor is a U.S. citizen and resident. Investor is the single member of a Delaware LLC ("LLC").
2. The investment vehicle chosen by the Advisors is a limited partnership (the "Partnership") formed under U.S. law. LLC will be the limited partner. Presidio Advisors, LLC will act as general partner and Manager. Both limited and general partners will contribute funds to the Partnership pursuant to the terms of the Partnership Agreement. The Partnership Agreement will require that investments, disbursements, and ongoing activities be accounted for using generally accepted accounting principles, including the maintenance of partnership capital accounts.
3. Upon the eventual termination of the Partnership, LLC and Manager will receive the amount of their capital account in a liquidating distribution. At LLC's option, LLC's capital account may be satisfied by a distribution of Partnership assets including foreign currency denominated securities and derivative contracts, as well as cash.
4. It is assumed that Investor does not have adequate liquidity to fully fund his commitment to the Partnership. Accordingly, Investor will negotiate a seven year loan (maximum length of the Program) from one of several pre-approved lenders. The borrower will be LLC. Terms of loan are described below.

III. Example – Investor's Loan

1. Investor's LLC borrows \$100 MM loan principal with additional \$50 MM loan premium on terms described below. Loan origination fee is payable to lender at Loan Issuance Date.

Loan Terms

- Issuance Fixing Date: March 4, 1999
- Loan Issuance Date: March 6, 1999
- Loan Maturity: February 28, 2006
- Initial Cash Amount: \$150,000,000
- Loan Principal Amount: \$100,000,000 [Loan Premium = \$150 MM - \$100 MM]
- Loan Principal Amount Due Date: \$100 MM payable February 28, 2006
- Coupon: [15.85]% [Assumes a loan rate of 7.00% and a premium of 8.85%]
- Coupon Payment Dates: Quarterly
- Loan Prepayment Penalty: May be applicable at Lender's request
- Transferability: With Lender's consent
- Loan Call Provision: Lender may call loan if collateral drops below stipulated level.

IV. Assumed Transaction Steps

1. LLC borrows \$150 from Lender on terms described above. LLC holds borrowed funds for at least 7 days. Investor pledges LLC interest to Lender to secure loan.
2. After 7 days or more, LLC contributes \$100 MM borrowed proceeds plus \$50 MM loan premium to Partnership. LLC also contributes additional \$3 MM.

3/4/1999

2

3. Partnership assumes liability for \$100 MM loan plus \$50 MM loan premium from LLC with lender's consent. Partnership may enter into 7 year fixed for floating rate swap with qualified Lender affiliate or another financial institution. Manager contributes \$0.3 MM to Partnership.
4. LLC and Manager pledge their partnership interests to Lender.
5. Partnership opens foreign currency trading account with Lender.
6. Lender holds all cash as collateral in addition to being custodian and clearing agent for Partnership.
7. All Partnership trades can only be executed through Lender or an affiliate.
8. Lender must authorize trades before execution.
9. Stage One of investment program as described below commences.
10. After 60 days, at Investor's election trading either proceeds to Stage Two or all outstanding trades are closed and loan is prepaid (subject to prepayment penalty, if applicable).
11. If Investor elects not to proceed to Stage Two, Partnership is liquidated.

V. The Investment Program – a Three Stage Approach with Increasing Levels of Risk

- Stage One – low risk tolerance: 30 to 60 days. For example, Partnership may make conservative bets to place at risk a portion (say 20%) of its capital. Such trades may include bets (forwards and FX options for example) that certain currencies currently pegged to the U.S. dollar (such as the Hong Kong dollar or Argentine Peso) will break the peg and devalue. Long U.S. dollar – short pegged currency.
- Stage Two – moderate risk tolerance: 120 to 150 days. The bets described in Stage One increased to utilize (say) 50% Partnership's capital. Long U.S. dollar – short pegged currency.
- Stage Three – high risk tolerance: 6.5 years. Strategies may include those which are the opposite of Stage One and Two to bet on the performance of currencies *after* they devalue. For example, Partnership could lend local currency (go long) after a devaluation and profit from high local interest rates and the appreciation v. the U.S. dollar that frequently follows a devaluation. (example – Indonesia)
- At the end of each stage, the Investor has the option to continue to the next stage or windup the Program and the Partnership. If the Investor elects to continue to the next stage, an additional capital contribution is required.

26 AUG 1999 10:18 FROM W D R ED GRP

10 1733/0346
10 15412P. 152-26
P. 152-26

Warburg Dillon Read

Date: 1-Mar-99
Ref. No.:**Equities****Large/Heavily Structured Transaction Approval**

Initiator:	S Polavaram	PL	Risk Dept.:	John Hogan	via email
Trading MD:	David Balls		Others:	WALL	SWALL
Distribution MD:	W Stolz	in the system			
Global Risk Co-ord:	M Wallace	see 1/9/99	Risk Model:	G Rajagopal	via email
			MRC:	B Chagger	via email

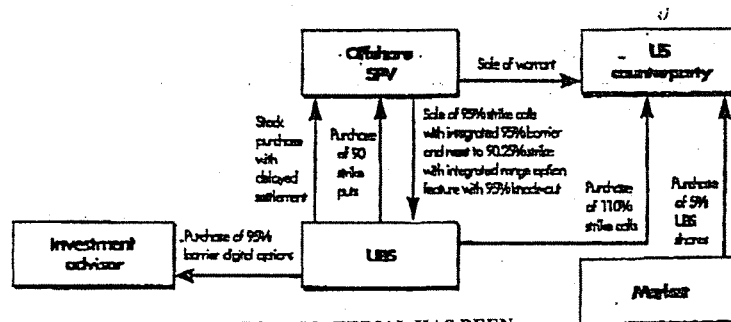
(Mandatory for all transactions involving regulatory, legal, tax or reputational risk)

Name of Transaction: UBS Redemption Trades

A) Overview of Transaction: (Sample Term Sheet attached)**1) Summary and Timescales of Transaction**

UBS redemption trade is the creation of a capital loss for U.S. tax purposes which may be used by a U.S. tax resident to off-set any capital gains tax liability to which it would otherwise be subject. The scheme relies upon the treatment accorded under the U.S. tax code to holdings by U.S. tax residents of shares in a foreign person and, in particular, certain attribution rules governing the redemption of such shares by the foreign issuer. The crux to the structure is that the redemption of foreign shares increases the tax basis of the shareholder by the amount of the redemption proceeds. The UBS redemption trades effectively recognise a redemption of shares for U.S. tax purposes and thereby uplift the recipient's base cost. Economically however, the shareholder will not have received a cash distribution. The scheme therefore exploits this asymmetry between the tax consequences and the economic reality. (Redemption Trade memo giving details is see appendix 1). Sample trade ticket attached. 50 day transaction.

Up to USD 500million in size.

SchematicPRIVILEGED MATERIAL HAS BEEN
REDACTED FROM THIS PAGE

¹ Reference WDR Risk Committee 22nd Oct 1998 minutes relating to one point of entry via Credit Risk Management on behalf of Credit risk, Market risk and New Business groups.

UBS000009

Approved on 01/03/99 13:02

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 272

Last Saved: 01/03/99 13:02

25 JUL 1999 10:10 FROM WDR R ED

 Warburg Dillon Read

2) Economic Rationale (both Client & WDR perspective).
Tax benefit for client.
2.00% edge + bid/ask spread

3) Collateral held (where & to whose order).
6.5% of Notional

4) Assumptions and transaction criteria.

B) Risk / Reward Analysis:

1) Expected exposure with revenue & timeframes (including credit risk analysis in conjunction with Credit Derivatives Desk when appropriate).
Exposure is less than 6.5% of notional that the client posts as collateral
WDR's revenue is effectively the excess of the 2 year put premium

2) Summary of cashflow analysis (detailed version attached where necessary).
attached

3) Risks and mitigations to minimise our exposure.

4) Worst case scenario.

Customer is over collateralized by 1.99%

C) Conditions precedent from approvers:
Legal/ Tax =>

Model risk => Std model reserve of 50bps of notional for Quadra trades must be applied.

Reviewed by: Markus G. G. G.

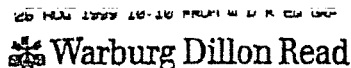
Date: 11/3/

*By J. Wall
(see First Panel)
in absence of
MG & CMB. 11/3/*

PRIVILEGED MATERIAL HAS BEEN
REDACTED FROM THIS PAGE

² In his absence - Colin Buchan plus either John Wall, Alex Easton or Mark Wallace

*Ek9
E208*



Appendix 1

U.S. Capital Loss Scheme - UBS "redemption trades"

The purpose of this note is to explain the background to, and structure of, the so-called UBS redemption trades. It also describes the due diligence and approvals process that had been originally undertaken within UBS and the views that were taken as regards the risks associated with this business.

Rationale

The essence of the UBS redemption trade is the creation of a capital loss for U.S. tax purposes which may be used by a U.S. tax resident to off-set any capital gains tax liability to which it would otherwise be subject. The manner in which this is achieved is described under Transaction Analysis below.

The tax structure was originally devised by KPMG Peat Marwick LLP ("KPMG") who issued a tax opinion as regards its likely efficacy for U.S. tax purposes. In very broad terms, the scheme relies upon the treatment accorded under the U.S. tax code to holdings by U.S. tax residents of shares in a foreign person and, in particular, certain attribution rules governing the redemption of such shares by the foreign issuer. The crux to the structure is that the redemption of foreign shares increases the tax basis of the shareholder by the amount of the redemption proceeds. The UBS redemption trades effectively recognise a redemption of shares for U.S. tax purposes and thereby uplift the recipient's base cost. Economically however, the shareholder will not have received a cash distribution. The scheme therefore exploits this asymmetry between the tax consequences and the economic reality.

We understand that Coopers & Lybrand have developed a variant to the KPMG scheme.


Origination of business

In October 1996, UBS was approached jointly by Quadra Capital Management LP.³ ("Quadra") and KPMG with a view to it seeking UBS' participation in a scheme that implemented the tax loss structure developed by KPMG. The role sought of UBS was one purely of execution counterparty. The marketing of the scheme to U.S. persons was to be carried out exclusively by KPMG and/or Quadra to their respective clients. It was clear from the outset - and has been continually emphasised since - that UBS made no endorsement of the scheme and that its connection with the structure should not imply any implicit confirmation by UBS that the desired tax consequences will be recognised by the U.S. tax authorities⁴.

³ Quadra is a U.S. multi-fund manager and hedge fund advisory boutique and with whom UBS had an existing relationship.

⁴ Though UBS is confident that, based upon its scrutiny of the tax opinion and of its authors, that the scheme is credible.

26 AUG 1999 18:18 FROM W D R ED GRP

14 1323/2046 11-11-11 11 11 11
10 03412
 Warburg Dillon Read

KPMG and Quadra each undertook to communicate this to any clients that expressed an interest.

UBS continues to be divorced from the advisory and marketing activities of KPMG and Quadra.

Transaction Analysis

A typical UBS redemption trade involves the following steps:

1. U.S. tax resident person ("X") purchases UBS shares (which may or may not be through UBS) on a delivery versus payment basis. The number of shares equates to 5% of the notional amount of the overall transaction size.
US tax implication: X has a long position in the UBS shares.
2. X also purchases a warrant from an off-shore special purpose vehicle ("SPV") which has been set up by Quadra for this purpose. The warrant grants X the right to purchase 80% of SPV's shares.
US tax implication: Under certain option attribution rules, X is treated as having beneficial ownership of SPV and, accordingly, the tax basis of SPV is consolidated with that of X.
3. UBS sells UBS shares to SPV (corresponding to the full notional of the transaction) but on the basis of delayed settlement after 51 days.
US tax implication: X is deemed to hold a long position in UBS shares acquired by SPV (which is aggregated with long position under 1. above).
4. At the same time, UBS buys from SPV an in-the-money call option relating to UBS shares and UBS sells to SPV an out-of-the money put option relating to the same number of UBS shares (which correspond to the full notional). The call incorporates a range bet feature which is designed to satisfy U.S. tax requirements for potential profitability. Ignoring the range option overlay, the options amount to a synthetic forward on the full notional amount.
US tax implication: X's investment in SPV offers the requisite potential for profits through the range bets. The strikes on the options are at variance to satisfy the requirement for market risk.
5. SPV deposits cash collateral with UBS as security for its obligation under the call option.
US tax implication: None
6. The options expire contemporaneously with the delayed settlement of the UBS share purchase by SPV under 3. above. UBS exercises the call option or SPV exercises the put option (whichever is in-the-money), thereby obligating SPV to deliver UBS shares to UBS in return for cash. The share delivery and cash payment obligations of the parties net against the corresponding share and cash obligations under the delayed settlement. No shares or cash is therefore moved, although book entries are recorded to that effect.
US tax implication: The exercise of the options is treated by the U.S. tax authorities as a redemption of stock by the issuer of the shares for a cash distribution. The amount of the cash payment increases the tax basis of the UBS shares owned by X directly and indirectly through the call option by the full amount of the distribution.
7. At the same time as the option expiry, X purchases from UBS 110% calls on UBS shares corresponding to the full notional of the transaction.

UBS000012

25 AUG 1999 18:18 FROM M D R TO UBS

TO 1233/2046 (M.D.R.) 07/11

 Warburg Dillon Read

US tax implication: Under the option attribution rules, X is treated as having a long position in the UBS shares. From SPV's perspective, it no longer owns UBS stock - which have been redeemed pursuant to the option exercise under 6. above - but is treated under reverse attribution rules as owning the shares owned by SPV (i.e. the 5% purchased under 1.) and the shares which X is deemed to own under the 110% call options. It is onto the tax basis of these shares that the redemption "distribution" is added.

8. X closes out the 110% calls and sells 5% shares.

US tax implication: X realises a capital loss for U.S. tax purposes.

Due Diligence

UBS undertook a thorough investigation into the propriety of its proposed involvement in these transactions. The following steps were undertaken:

Compliance: a full check was made of Quadra and its associates to ensure that there were no money laundering or other improper implications to the scheme.

Legal:

PRIVILEGED MATERIAL HAS BEEN
REDACTED FROM THIS PAGE

UBS000013

3695

25 AUG 1999 10:18 FROM W D R ED SRP

TO 133010346 P. 07/99
TO 83412 P. 07/99

 Warburg Dillon Read

Further information

Wolfgang Stolz (x16349), Chris Donegan (x14589) and/or John Staddon (x13549) are available to discuss further any feature of the UBS redemption trades.

Addendum

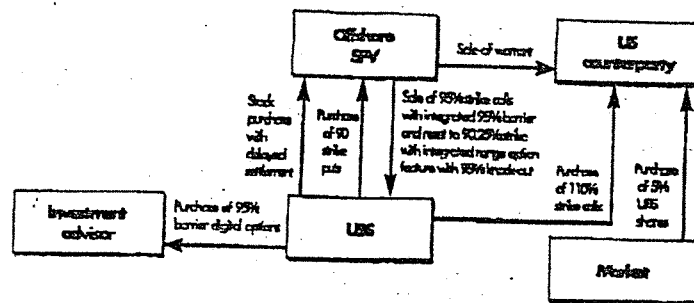
PRIVILEGED MATERIAL HAS BEEN
REDACTED FROM THIS PAGE

26 AUG 1999 10:11 FROM W D R ED GRP

TO 1535 0345 IN: JEEP, BE 17/11
TO 63412 P. 08/08

Warburg Dillon Read

Schematic



13-NOV-1997 17:55 FROM UBS LTD

TO

11298 P.01/05



☒ Notice
Notiz
Nota
Memo

☐ Procès-verbal
Protokoll
Verbale
Report

☐ Proposition/Demande
Antrag/Anfrage
Proposta/Richiesta
Request/Inquiry

☐ Prise de position
Stellungnahme
Parere
Reference/Opinion

Destin à
Destinataire
Addressed to

S. Schulman / W. Bonadurer

Expedition/Destination/Adresse

Tel./Tel.

Andreas Schlegel

16911

Copie pour information à
Kopie zur Kenntnisnahme an
Copie per conoscenza a
Copy for information to

H.-P. Bauer
R. Goldstein
M. Phillips

Lieu/Ort/Ort/Place

Date/Datum/Date/Date

GTRI London

13-Nov-97

Objet
Gegenstand
Oggetto
Subject

Description of the UBS "Redemption" Structure

As requested, please find below a high-level description of GED's UBS "Redemption" structure that is colloquially called "Quadra" structure. The term "Redemption" structure is used throughout to differentiate this particular structure from other transactions involving "Quadra".¹ This note explains the structure in simplified terms. A more detailed analysis will follow later.

1. Motivation

The motivation for this structure is tax optimisation for U.S. tax residents who are enjoying capital gains that are subject to U.S. tax. The structure creates a capital loss from a U.S. tax point of view (but not from an economic point of view) which may be offset against existing capital gains.

2. "Redemption" structures executed year-to-date (12-Nov-97)

GED did approximately CHF 1.77 billion notional of the "Redemption" trades so far this year. Thereof there are currently about CHF 640 million outstanding which will roll into the 110% calls (please see 5. @ below) over the next 3 to 4 weeks. There are no additional trades in this structure scheduled for the rest of this year.

GED make an average profit of about 3% on these transactions. Year-to-date this amounts to roughly CHF 53 million. This money is earned on both option premium and trading.

For January 1998 GED has an order from BancOne for a USD 500 million transaction.

3. Entities involved

The entities involved in a typical "Redemption" structure are:

- U.S. tax resident "X" enjoying or expecting to realise in the current tax year capital gains that are subject to U.S. tax;
- Off-shore SPV;
- Tax advisor (e.g. KPMG, Coopers & Lybrand);
- Quadra Capital Management, L.P.;
- UBS.

¹ Quadra Capital Management, L.P. - a U.S. based multi-fund manager and hedge-fund advisory boutique.
quadra.doc

Commentaire

Kommentar

Commento

Comment

Responsible

Verantwortlich

Responsabile

Responsible

Date

Termin

Termine

Datum

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 274

UBS000031

13-NOV-1997 17:55 FROM UBS LTD

TO

11298 P.02/05



Objet
Gegenstand
Oggetto
Subject

Page
Seite
Foglio
Page

4. Typical transaction

A typical "Redemption" transaction can be summarised as follows:

- Maturity approximately 80 days;
- Underlying UBS bearer shares.
- Average notional amount USD 25 million (roughly 20,000 shares).

5. High-level description

The subsequent numbers relate to the numbers on both the attached diagram and table.

① On-shore U.S. tax resident person "X" opens a brokerage account with UBS New York in accordance with the normal account opening procedures. "X" then uses this account to buy and hold UBS shares on a delivery versus payment basis. The number of shares that "X" buys corresponds to about 5% (arbitrary number) of the notional amount of the transaction described in this document.

U.S. tax implication: "X" has a long position in UBS shares.

② The tax advisor to "X", who works together with "Quadra", sets up an off-shore SPV. This SPV sells a warrant on its own shares on 80% of its capital to "X" in exchange for cash.

U.S. tax implication: "X" has beneficial ownership of the SPV. The tax basis of the SPV is consolidated with that of "X".

③ UBS Zurich sells UBS bearer shares to the SPV. The number of shares sold corresponds to the full notional amount of the transaction. The transaction allows for a delayed settlement, i.e. the settlement of cash versus shares is scheduled to take place only after 51 days.

U.S. tax implication: "X" is deemed to hold a long position in UBS bearer shares equivalent to the notional amount of the delayed settlement of the transaction. The consolidated long position in UBS is the notional amount plus 5%.

④ At the same time as ③ above, UBS London buys from the SPV in-the-money digital calls with a range bet feature on UBS bearer shares and the SPV buys from UBS London out-of-the-money puts on UBS bearer shares. The number of calls and puts corresponds to the full notional amount of the transaction. Effectively this options strategy, that was developed by GED after discussions with "Quadra", represents a synthetic forward on the full notional amount plus some range bets.

U.S. tax implication: The economic rationale for "X" investing in the SPV is that the SPV offers the potential for significant profits based on the embedded series of range bet options within the calls. The specific strikes of the puts and calls are set in line with the specific requirements laid down in the U.S. tax

quadra.doc

Commentaire	
Kommentar	
Commento	
Comment	
Trasmissione	
Verantwortlich	
Responsabile	
Responsible	
Titolo	
Turnover	
Qualità	

UBS000032

TO

11290 P.03/05



Objet
Gegenstand
Oggetto
Subject

Seite
Foglio
Page

Cone mceclars
Konvertierbar
Commence
Cernent
Responsable
Verantwortlich
Responsible
Rasparabile

Dadas
 Terrenas
 Terrenas
 Dadas

③ The options described in ② expire after 51 days. The SPV delivers shares for cash according to ② and UBS delivers shares for cash according to ③ (delayed settlement). The number of shares and the amount of cash that have to be delivered out of ② and ③ net each other, i.e. net net there is no purchase or delivery of UBS shares at all.

U.S. tax implication: U.S. tax authorities treat the nominal exercise of the call or put options described in ④ as a redemption of stock for a cash payment. This cash payment increases the tax basis of "X" by the full notional amount.

⑥ At same time as ⑤ (and maturity of ④ and delayed settlement of ③) "X" buys from UBS London 110% calls on the same number of UBS bearer shares as above.

U.S. tax implication: This call provides "X" with a long position in UBS shares from a U.S. tax perspective. On a consolidated basis the long position therefore remains unchanged, i.e. the 110% calls entirely offset the long position redeemed under Q. In addition, the consolidated position shows a long cash receipt in relation to the redemption. From a U.S. tax perspective, although not economically, "X" has received a distribution (the redemption proceeds). The taxable value of the consolidated position is now two times the notional amount (redemption proceeds plus value of 110% calls).

⑦ Within one month "X" closes out the calls described in ⑥ above for cash.

U.S. tax implication: Before closing out the calls, from a tax perspective "X" is long both cash and UBS bearer shares. Although in reality "X" is long an option (low premium) and net flat cash. After closing out the calls "X" realises a capital loss, i.e. "X" had a long UBS position with a tax basis of two times the notional amount but the close-out value is at maximum the notional amount plus the value of the calls.² On a consolidated basis "X" is able to use the capital losses against other capital gains he/she may have.

² The total capital loss position is calculated from:

Tax value of UBS position (two times notional amount) *plus* proceeds from range bet options *minus* value of 110% calls. For simplicity the attached table ignores the range bet options.

13-NOV-1997 17:56 FROM UBS LTD

TO

11298 P.04/05



Objet
Gegenstand
Oggetto
Subject

Page
Seite
Foglio
Page

Commentaire	
Nummer	
Commentaire	
Comment	
Responsable	Dien
Verantwortlich	Termin
Responsabile	Termin
Responsabile	Deadline

6. Risks

Market risks

From a UBS perspective the main market risks of the "Redemption" structures are as follows:

- The cumulatively very large size in one name (UBS);
- The large short UBS gamma of the 110% calls (5.0 above) that exposes GED to price gap risk. This requires a significant pre-positioning in long UBS gamma. To give an illustration, in anticipation of the forthcoming sales of 110% calls GED is currently about CHF 14 million long UBS gamma;
- The net gamma of the long call/short range bets/long puts (5.0 above).

Experience shows that these risks are manageable:

- 4 to 5 series of successful structures with approximately 85 counterparties are already off GED books;
- The 110% calls (5.0 above) are cash settled and clients usually either close them out well before expiration or even leave an order to close them out early. For all outstanding transactions clients agreed up-front to close the calls out as soon as the premium is 2.5%. This significantly reduces the price gap risk.
- GED actually made money trading the net gamma of the long call/short range bets/long puts (5.0 above).

Tax/reputation risks

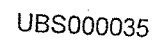
UBS is exposed to indirect tax/reputation risk:

- Any potential exposure is indirect because UBS does not directly advise the customers ("X"). The customers deal only with their tax advisors who are normally KPMG or Coopers&Lybrand who then in turn deal with either Quadra, Deutsche Bank, or ABN Amro.
- The soundness of the structure has been confirmed from both a tax perspective (KPMG, Coopers&Lybrand) and from a legal perspective (Brown&Wood; Skaddon, Arps, Meagher & Flom) and a variety of other U.S. and European law and tax firms as requested by each underlying client, i.e. "X".
- The legal/tax analysis has provided a "should do" opinion. This protects all counterparties against punitive damages from the IRS resulting from retrospective U.S. tax law changes. In the event that the structure is challenged possible outcomes are:
 1. Transaction is prohibited in the future;
 2. "X" is forced to pay his/her capital gains tax;
 3. "X" is forced to pay interest for the period at a rate of 8%.
 This means for "X" that he/she must employ his/her capital to earn 8% or more in order to avoid a net loss from the transaction in a worst case.

Andreas Schlegel
Andreas Schlegel

quadra.doc

UBS000034



13-NOV-1997 17:56 FROM UBS LTD

TO

11298 P.06/85

UBS "Redemption" Structure
(U.S. tax resident's perspective)
(Relevant bookings assuming a notional amount of 100)

Economic Analysis					Tax Analysis							
	Assets	Liabilities	Cash	(-) P&L	Net		Assets	Liabilities	Cash	(-) P&L	Net	
①	Buy shares	5	0	-5	0	0	Buy shares	5	0	-5	0	0
②③	Buy shares (delayed settlement)	100	-100	0	0	0	Buy shares	100	0	0	(*) -100	0
④	UBS exercises call	-100	100	0	0	0	Asset change (redemption)	100	0	0	0	0
⑤	Buy 110% calls	1	0	-1	0	0	Call	100	0	0	(*) -100	0
⑥	Close out calls (&)	-1	0	2	-1	0	Close out of call	-200	0	100	(#) 100	0

Comments:

(-): Negative number is profit, positive number is loss.

(&): Assume profit of 1

(*): Not a tax event

(#): A tax event

TOTAL P.06

UBS000036

3703

John Stoddon
John Stoddon

Markus Granziol
SBC Warburg Dillon Read
1 Finsbury Avenue
London EC2M 2PP

February 12, 1998

RE: US tax avoidance scheme being sold by Equity Derivatives group

Dear Mr. Granziol:

I am an insider in the capital markets department of the new UBS. I am writing this note to let you know that Global Equity derivatives is currently offering an illegal capital gains tax evasion scheme to US tax payers. This scheme is costing the US Internal Revenue service (IRS) several hundred million dollars a year. I am concerned that once IRS comes to know about this scheme they will levy huge financial/criminal penalties on UBS for offering tax evasion schemes.

The scheme involves using UBS bearer shares to manufacture artificial capital losses which are then used to offset capital gains tax liability. The scheme is jointly being distributed in partnership with a small boutique based in the US. I believe the following people within Equity Derivatives are involved in the scheme: Wolfgang Stoltz, Chris Donegan and John Staddon. In 1997 several billion dollars of this scheme was sold to high networth US tax payers, I am told that in 1998 the plan is continue to market this scheme and to offer several new US tax avoidance schemes involving swaps.

My sole objective is to let you know about this scheme, so that you can take some concrete steps to minimise the financial and reputational damage to UBS. If no steps are taken within the next 30 days I am afraid I will have to send a copy of the trade description to a special investigation cell in IRS.

Thank you for your attention

Regards

Chris

Chris Smith

P.S. I am sorry I cannot disclose my identity at this time because I don't know whether this action of mine will be rewarded or punished

cc: Alan Hodgson

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 275

UBS000038

3704

X-Nextstep-Mailer: Mail 3.3 (Enhance 1.3)
From: Chris Donegan <don>
Date: Wed, 18 Feb 98 14:19:28 GMT
To: wolfgang
Subject: ubs trades : ANONYMOUS LETTER TO GRANZIOL

Wolfgang,

Marcus Granziol has recieved an anonymous letter relating to the UBS trades and their "fraudulent" nature.

You, me and Staddon are named and the trade described in some detail.

I have sent (via Ruwan) the Schlegel memo plus the memo John wrote at yesterday's meeting with Jean Short to Bonadurer in response to this.

My votes are: Mahaffy, Freiman, Manit, or Ellis as authors.

The Note appears to have been sent from a US location by a member of the "Capital Markets" team of the new bank.

It seems that the knives are out.

Granziol has stated to Ruwan his reservations in executing this type of business in large size. I guess we need to determine what "large size" means.

Don

UBS000037

(50) Users 3 / Wolfgang / Mailboxes / Don's mailbox / UBS trades / Anonymous letter

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 275

3705

X-Nextstep-Mailer: Mail 3.3 (Enhance 1.3)
From: Chris Donegan <don>
Date: Thu, 19 Feb 98 11:59:29 GMT
To: wolfgang
Subject: Lunch and anonymous letters

I am with Tom at the Italian.

Also, Mark Harding .

I have spoken with Schlegel and Chris Reed re: this and said that we want to avoid any stupid knee-jerk reactions to anonymous letters but given the sensitivity of the current situation we have advised the client that we will delay until after the next dividend,

I also explained that in future if our competitors want to stop us doing business then an anonymous letter is all that is required - this is clearly stupid. Paul Spanswick, Andreas Schlegel are on our side in this matter, but for now Bonadurer is beating the drum.

Don

PRIVILEGED MATERIAL HAS BEEN
REDACTED FROM THIS PAGE

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 275

UBS000225

3706

In-Reply-To: <90E0009FCE8AD11186C50060976CE313047D97@QUADRADELL>
X-Nextstep-Mailer: Mail 3.3 (Enhance 1.3)
From: Chris Donegan <don>
Date: Fri, 27 Mar 98 17:26:14 GMT
To: Norm Bontje <NormB@qcm.com>
Subject: Re: Redemption Trade
Cc: wolfgang, john.staddon@ny.ubs.com

Norm.

as you are aware Wolfgang and I are presently unable to execute any redemption transactions on UBS stock.

The main reason for this seems to be a concern within UBS that this trade should be registered as a tax shelter with the IRS.

While the debate continues we cannot execute any legs of the transaction and this includes buying UBS stock for counterparties.

Whilst I understand that buying stock does not of itself constitute a tax sensitive act, unfortunately the current restraining order is not specific.

Wolfgang and I are working hard to resolve the situation and have made some good progress, however we are not there yet.

Sorry to have to create a problem for you with these clients but I hope that this explains the background adequately.

Bye the way Jim Pasquale resigned from UBS yesterday. He will be gone in 2 weeks. In the interests of efficient execution therefore please liaise with me directly or Adam Matthews rather than New York as the personnel changes in UBS mean that we will have to allocate work from London to the most appropriate person for a while.

regards

Don

UBS000039

(604) UBS 3 / Wolfgang / Matthews / Don mbr / Re: redemption trade

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 275

March 27, 1998

Mr. Jeffrey Greenstein
CEO
Quadra Advisors, LLC
999 Third Avenue
Suite 4150
Seattle, WA 98104

Dear Jeff,

We are writing to discuss the applicability in the Redemption Transaction of requirements to register tax shelters with the IRS and related penalties as well as other penalties that the IRS can assert with respect to the organization, promotion and sale of interests in a tax shelter.

Issues

1. Does the Redemption Transaction qualify as a tax shelter?
2. Does the Redemption Transaction have to be registered with the IRS?
3. What are the potential penalties that could be asserted by the IRS if the Redemption Transaction is not registered, and what other penalties could be asserted by the IRS?

Conclusions

1. We believe that the Redemption Transaction qualifies as a tax shelter under IRC Section 6111.
2. We believe a reasonable position is that the Redemption Transaction will qualify as a foreign tax shelter and therefore is not required to be registered.
3. The penalty for failure to register a tax shelter provided in Section 6707(a)(1) and (a)(2) can be asserted by the IRS. The amount of this penalty is equal to the greater of 1 percent of the aggregate amount invested in the transactions or \$500. Other penalties that the IRS could assert, as applicable, are those provided in: Section 6707(b) for failure to furnish a tax shelter identification number, Section 6700 for activities in connection with the promotion of abusive tax shelters, Section 6701 for aiding and abetting in the understatement of tax liability and Section 6708(a) for failing to keep lists of investors.

Analysis

Pursuant to Internal Revenue Code ("IRC") Section 6111, any tax shelter organizer must register the shelter with the IRS not later than the day of the first offering of sales of interests in such tax shelter. A "tax shelter" is defined under that section as any investment that is expected to

Mr. Jeffrey Greenstein
Quadra Advisors, LLC

Page 2

produce cumulative U.S. tax deductions which are greater than twice the cumulative investment at any time during the first five years following the date the investment is first offered for sale; and which investment is:

- a) required to be registered under a Federal or State law regulating securities;
- b) sold pursuant to an exemption from registration requiring the filing of a notice with a Federal or State agency regulating the offering or sale of securities; or
- c) a substantial investment, defined to be an investment for which the aggregate amounts offered for sale exceed \$250,000, and for which there are expected to be five or more investors.

The Redemption Transaction will clearly produce U.S. tax deductions of greater than twice the investment. The Redemption Transaction is not subject to Federal or State registration requirements, but does meet the definition of a substantial investment.

Foreign Tax Shelters

Section 6111(f)(4) states that the "Secretary may prescribe regulations which provide such rules as may be necessary or appropriate to carry out the purposes of this section in the case of foreign tax shelters".

The question of what is a "foreign tax shelter" and the registration requirements if any, for foreign tax shelters in the absence of such regulations is unanswered. Temporary Regulations issued pursuant to Section 6111 which were released on August 13, 1984 do not address the issue of foreign tax shelters.

We believe that until and unless applicable regulations are issued, a position that the registration of the Redemption Transaction with the IRS is not required (because it is a foreign tax shelter) is reasonable.

Penalties for Failure to Register

Section 6707(a)(1) and (a)(2) provide for a penalty equal to the greater of 1 percent of the aggregate amount invested in a "tax shelter" or \$500 for failure to timely register a tax shelter or for the filing of false or incomplete information with respect to a tax shelter registration. Regulation 301.6707-1T, A-1, provides that the amount invested is computed in accordance with Regulation 301.6111-1T. The latter Section provides that the investment amount includes all cash paid, the fair market value of any property transferred and the principal amount of indebtedness incurred by the investor to acquire the investment interest.

Corporate Investments Offered Under Terms of Confidentiality

Section 6111(d) enacted as part of the Taxpayer Relief Act of 1997 expands the definitions of the term "tax shelter" to include certain investments offered expressly or implicitly under conditions

UBS000041

Mr. Jeffrey Greenstein
Quadra Advisors, L.L.C.

Page 3

of confidentiality which have a significant purpose of reducing the tax liability of a corporate taxpayer. The rules provided in this section are applicable to any such tax shelter interest which is offered for sale after the IRS prescribes guidance with respect to this new section.

Section 6707(a)(3) provides that penalties for failure to register a tax shelter offered under terms of confidentiality described in 6111(d), or for providing false or incomplete information to the IRS with respect to such registration, is the greater of 50 percent of the fees paid to all promoters or \$10,000. The penalty limit will increase to 75 percent of the fees if the failure is intentional. Sections 6111(d)(3) and 6707(a)(3) expand the parties potentially liable to register tax shelters to include each U.S. person who discussed participation in the tax shelter, but only to the extent of 50 percent of the fees paid by the participant in all promoters.

Aggregate Amount Invested

Absent any regulation providing special rules for foreign tax shelters, the aggregate amount invested should be limited to amounts paid and debt incurred by U.S. investors. The stock investments and financing transactions of a foreign corporation should not be relevant. Therefore, in the case of the Redemption Transaction, the aggregate amount invested should be equal to the cost of the warrant plus the cost of any securities purchased. The penalty amount should be equal to 1% of such amount.

Failure to Furnish a Tax Shelter Identification Number

Section 6707(b) provides a penalty of \$100 for each failure to furnish a tax shelter identification number.

Other Tax Shelter Related Penalties

Other possible penalties which the IRS can assert with respect to tax shelters include:

- a) Section 6700 which provides penalties for activities in connection with the promotion or sale of interests in abusive tax shelters. These penalties are limited to \$1,000 per activity and only apply where an organizer, promoter or seller makes or furnishes a statement with respect to the availability of any tax benefit which it knows or has reason to know is false or fraudulent as to any material matter or makes a "gross valuation overstatement" as to any material matter. We do not believe the Redemption Transaction will be considered an abusive tax shelter.
- b) Section 6701 which provides penalties for aiding and abetting in the understatement of tax liability which is limited to \$10,000 with respect to an understatement of the liability of a corporation and \$1,000 with respect to an understatement of the liability of other taxpayers. This section is applicable to any person in connection with the preparation or presentation of any portion of a document who knows or has reason to believe that such portion will be used in connection with a material tax matter, and that if so used, will result in the understatement of another person's tax liability. The penalties can be applied on a document by document

UBS000042

SENT BY: COOPERS AND LYNN 3-6-

Mr. Jeffrey Greenstein
Quadra Advisors, LLC

basis, but are limited to the amounts stated above for each taxpayer, for each of the taxpayer's taxable periods. No penalty shall be assessed under Section 6700 with respect to promoting abusive tax shelters on any person with respect to any document for which a penalty is assessed on such person under Section 6701. This penalty is typically imposed on tax preparers who give tax advice with respect to the preparation of tax returns, not tax shelter organizations.

- e) Section 6708(a) which provides that where an organizer or seller of a potentially abusive tax shelter fails to keep lists of investors as required under Section 6112, a penalty of \$50 for each person with respect to which such failure occurred will apply.
- d) Regulation 301.6111-1T, A-2 in reply to the question "Are penalties provided for failure to comply with the requirements of tax shelter registration?" discusses the penalties under Section 6707 described above. It is stated therein that "In addition, criminal penalties may be imposed for willful noncompliance with the requirements of tax shelter registration" citing Section 7203, relating to willful failure to supply information and Section 7206, relating to fraudulent and false statements. Penalties under the later two sections would of course not be relevant to the Redemption Transaction.

Please note that the information provided herein is based on facts as stated and authorities that are subject to change or differing interpretations.

I feel free to call me at 212-259-3025 if you have any questions or comments.

Sincerely,

Michael Schwartz

UBS00004

3711

Springer, Mark A

From: Ammerman, Douglas K
Sent: Friday, December 10, 1999 1:36 PM
To: Lanning, John T; Stein, Jeff (US/Vice Chairman); Lippman, Michael H; Springer, Mark A; Smith, Richard H (WNT); Brockway, David H; Brian Rivotto; Carolyn Branan; David Zaudtke; Dennis Ito; Glen Wright; James Duty; Jeffrey Eischeid; Mark Watson; Neil Tendler; Neil Wolfson; Robert Pedersen; Robert Perez; Tracie Henderson; William Goldberg
Subject: Innovative Strategy Development

This message is to provide you with a brief update on the development efforts of various strategies. Subject to requisite Firm approval, I intend to have a video conference with all PFP professionals in January to review those strategies we intend to emphasize during the remainder of FY 2000.

- **BLIPS 2000.** Randy Bickham has been working on a white paper on this strategy which uses a loan premium structure within a Delaware Business Trust. Randy presented a draft of this document to Mark Watson for his input. Mark and Randy will meet next week. Subject to Mark's input, a final white paper will be provided to David Brockway, Richard Smith and Mark Springer.
- **FORTS (a Quadra product).** We are aggressively pursuing the review and development of this loss generating strategy. There are some technical issues that still need to be resolved, and we expect to have more definitive information within the next week regarding whether this is a viable product.
- **FLIPS.** Dave Smith indicated that the target date to complete the white paper on this loss generating strategy is January 31. Subject to Firm approval, we anticipate being able to market this product in February.
- **Charitable Limited Partnership.** The final white paper for this estate and income tax planning strategy is almost complete and ready for DPP-Tax's final review.
- **WEST (a Quadra product).** We are waiting on additional information from Quadra to complete our review and approval of this conversion strategy.
- **OPIS.** Assuming we are unsuccessful in developing any of the above strategies, I will be contacting you regarding our ability to pursue a limited number of OPIS strategies for 2000. Obviously, this would also be subject to Larry DeLap's input and approval.

While I will keep you posted concerning additional updates, I would like to have a conference call late December to address product development and marketing efforts for the remainder of FY 2000. Please call with any questions.

Doug Ammerman
Personal Financial Planning
KPMG LLP
Orange County Office
(714) 850-4455
Fax (714) 850-4410
dammerman@KPMG.com

1

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 279

KPMG 0036736

**Memorandum on UBS' involvement in
U.S. Capital Loss Generation Scheme (the "CLG Scheme")**

1. The CLG Scheme

- 1.1 In October 1996, GED was approached by Quadra Capital Management ("Quadra") and KPMG Peat Marwick LLP ("KPMG") with a view to seeking GED's participation in a U.S. tax structure that had been developed on a proprietary basis by KPMG. The principal design of this scheme is to generate significant capital losses for U.S. tax payers which can then be used to offset capital gains which would otherwise be subject to tax. The analysis by which this is achieved is complex and is the subject of a tax opinion that was prepared by KPMG for marketing purposes. In very broad terms, the scheme exploits an apparent loophole in the U.S. legislative provisions governing the treatment of shareholdings in a foreign person and certain attribution rules relating to the redemption of the shares comprised in that shareholding. The steps involved in the structure are described more fully below.
- 1.2 The CLG Scheme was developed and marketed solely by KPMG. UBS undertook no responsibility for the efficacy of the scheme and stressed both orally and in writing to both KPMG and Quadra that UBS made no endorsement or confirmation of the scheme on any ground whatsoever. KPMG and Quadra agreed to communicate this to their clients. Nevertheless, GED had an interest in ensuring that the putative rationale of the transactions in which it was invited to enter into stood up to proper and diligent scrutiny. The KPMG opinion was reviewed in detail and a partner of KPMG (David Lippmann-Smith) came to London to go through its finer points. Whilst it was not possible (nor, for that matter, necessary) to assess in any expert sense the legal accuracy of the analysis or the conclusions of the opinion, it was nonetheless evident that the scheme had a bona fide and commercially driven purpose in connection with which no ulterior or underhand design could be suspected.

2. The Role of Quadra

- 2.1 Quadra has an existing relationship with GED and had previously arranged a number of transactions on behalf of its clients. Its speciality is providing tax efficient investment schemes for high net worth U.S. individuals and their investment vehicles. Jeff Greenstein is the principal contact at Quadra who, following his initial introduction to GED, has visited UBS London on a number of occasions. Both Jeff and Quadra have been subject to on-going due diligence throughout this period and have received UBS compliance clearance.
- 2.2 Quadra was not directly involved in the marketing of the CLG Scheme. Its role is in arranging the involvement of a non-U.S. equity derivatives provider.

3. The Transactions

- 3.1 UBS' involvement in the CLG Scheme involved entry into the following transactions:
- (a) on day one, UBS Zurich sold UBS bearer shares (via UBS Securities Inc.) to a U.S. tax resident person ("X");

(b) UBS Zurich then sold UBS bearer shares to an off-shore entity ("Off-Co") established for that specific purpose by X. Settlement of these stock purchases is on a delayed basis (for which Zurich regulatory sign-off was obtained);

(c) at the same time as (b) UBS London ^{bought from} ~~sold~~ Off-Co an in-the-money call option, whilst Off-Co ^{bought from} ~~sold~~ UBS an out-of-the-money put option, in each case over the same number of UBS London bearer shares as were the subject of the delayed settlement purchase. Both options are physically settled. The original strike of the call was set at 95 which reduces to 90 if the stock price hits a barrier of 95. The strike on the put is also subject to a similar barrier feature, the purpose of which was to cheapen the option cost;

(d) Off-Co deposits cash with UBS London as security for Off-Co's potential obligation under the put option;

(e) simultaneously with the expiration of the options referred to in (c), X purchase from UBS London an at-the-money call option over the same number of shares as it originally acquire under (a).

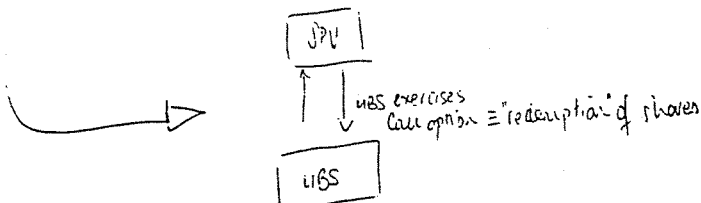
(The documents evidencing the above transactions are in safekeeping with DELG.)

3.2 X and Off-Co are connected for tax purposes by virtue of X's investment in a warrant issued by Off-Co in respect of its own shares. This link is important for the U.S. tax analysis, since it effectively attributes to X any losses Off-Co incurs as a result of its ownership of the UBS shares. The exercise of the call option or put option between UBS and Off-Co will be treated for U.S. tax purposes as a redemption of shares, notwithstanding the fact that, according to KPMG, such exercise will not be a share redemption for UBS purposes. The proceeds of this "redemption" is treated as the payment of a distributable reserve, the receipt of which by Off-Co is attributed to X as a deduction to X's base cost in its holding of UBS shares. This generates a sizeable capital loss for X.

4. Legal Due Diligence

5. Further Information

For matters pertaining to the legal structure, please contact John Staddon in DELG.



PRIVILEGED MATERIAL HAS BEEN
REDACTED FROM THIS PAGE

UBS000007

Watson, Mark T

From: Mcconnachie, Barbara
 Sent: Thursday, May 13, 1999 7:46 PM
 To: Lanning, John T; Stein, Jeff; Lippman, Michael H; Wiesner, Philip J; Watson, Mark T; DeLap, Larry
 Subject: FW: BLIPS

I am beginning to think that the name BLIP was selected because this product promises to be just a "blip" on our financial statements. I wholeheartedly agree with Phil Wiesner's message this morning outlining where we are at this point and the incredible support we have received from WNT to craft a tax opinion that satisfies the more-likely-than-not standard.

One week ago, I assembled a special BLIPS task force in Dallas to deal specifically with the following issues:

1. Educating a select group of professionals regarding the technical aspects of this product.
2. Review of the risk-management aspects of the product.
3. Review of marketing plan and the product's fee potential.

While John Larson initially indicated that it may take Deutsche Bank and Sherman & Sterling up to 60 days to produce the relevant documentation, it is my understanding that efforts by all parties have been accelerated and that we are currently expecting documentation to be completed no later than the end of this month. In that regard, it is my understanding that Presidio has 2 individuals permanently housed at Sherman & Sterling to assist in the necessary documentation. Similarly Deutsche Bank is dedicating resources necessary to complete their documentation. In fact, at the end of this month, Jeff Eischeid will be attending a meeting in Frankfurt to address the issue of expanding capacity at Deutsche Bank given our expectation regarding the substantial volume expected from this product.

Mark's concerns (which were based upon comments made by Presidio at the Dallas meeting) are being addressed both by Presidio and Deutsche Bank. In my opinion, Mark's comments should in no way delay or reinstate our internal approval process. It is important to recognize that part of the agreement I made with Larry DeLap is that every BLIP transaction will receive the joint approval of both Mark Watson and Jeff Eischeid. To insure that we have proper risk-management control over this product, every opinion letter and every engagement letter will be subject to such joint approval.

In short, it is my understanding that this product has been examined by all appropriate technical resources in WNT and that all material issues that have been raised are being incorporated into the documents. The validity of the transactions will be subject to the actual facts as Phil pointed out. In that regard, I am fully confident that by having Mark and Jeff both reviewing each transaction that we will be able to avoid some of the technical issues that are currently being discussed in the abstract.

I concur with Jeff.

Doug

Doug Ammerman
 KPMG LLP
 Orange County Office
 (714) 850-4455

-----Original Message-----

From: Stein, Jeff
 Sent: Monday, May 10, 1999 11:05 AM
 To: Wiesner, Philip J; Lanning, John T; Ammerman, Douglas K
 Cc: Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
 Subject: RE: BLIPS

I think it's shit OR get off the pot. I vote for shit.

-----Original Message-----

From: Wiesner, Philip J
 Sent: Monday, May 10, 1999 9:51 AM
 To: Lanning, John T; Ammerman, Douglas K
 Cc: Stein, Jeff; Lippman, Michael H; Smith, Richard H (WNT); Watson, Mark T; Rosenthal, Steven M; DeLap, Larry
 Subject: RE: BLIPS

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 284

MTW 0045

3715

John/Doug: Many people have worked long and hard to craft a tax opinion in the BLIPS transaction that satisfies the more likely than not standard. I believed that we in WNT had completed our work a month ago when we forwarded the opinion to Larry. Based on my attendance at numerous technical meetings and my reading the opinion, I came to the conclusion that we could reach an overall more likely than not tax opinion based on the information provided re business purpose and potential profit and the representations to be provided by the investor and Presidio. We viewed our role as a positive one, ie, we would work very hard to achieve, if possible, the desired level of opinion and suggest improvements, in particular, to limit the risks which the Firm is assuming by issuing the opinion.

The speed to market issue is also troubling to me, but perhaps for different reasons. First, this is a classic transaction where we can labor over the technical concerns, but the ultimate resolution - if challenged by the IRS - will be based on the facts (or lack thereof). In short, our opinion is only as good as the factual representations that it is based upon. As the courts did in the individual tax shelter cases of the 80s and in the recent ACM case, the decision will be based not on the technical niceties, but on the overall issues of whether in fact the investors approached the transaction from a business like point of view with a real desire to make a profit other than from tax benefits. Second, we have been dealing with a true prototype opinion where the facts keep evolving. The real "rubber meets the road" will happen when the transaction is sold to investors, what the investors' actual motive for investing the transaction is and how the transaction actually unfolds. Our opinion will be worth little (but we will be protected from risk if it is properly caveated) is the actual facts bear little relation to the assumed facts in the opinion. Note: This is Mark Watson's primary concern based on the recent Presidio discussions at a PFP meeting. Third, our reputation will be used to market the transaction. This is a given in these types of deals. Thus, we need to be concerned about who we are getting in bed with here. In particular, do we believe that Presidio has the integrity to sell the deal on the facts and representations that we have written our opinion on?! We have had past experience in the foreign stock redemption and the OPUS transactions which shows how difficult it is to keep the facts in line. Thus, the process has been slowed by a number of very critical forces which have been at work.

Having said all the above, I do believe the time has come to shit and get off the pot. The business decisions to me are primarily two: (1) Have we drafted the opinion with the appropriate limiting bells and whistles (Yes, in my opinion), has the engagement letter been drafted with the right risk limiting language (from what I have seen, Yes) and is the marketing of the transaction limited to very sophisticated taxpayers who are made aware of the risk and properly advised by their own tax and investment advisers (I thought that the marketing here was to be limited to a very small and narrow range of risk taking individuals!) and (2) Are we being paid enough to offset the risks of potential litigation resulting from the transaction? If the answers are yes to both questions, then we have done all we can do from a technical point of view and it is time to move on and decide the business case. My own recommendation is that we should be paid a lot of money here for our opinion since the transaction is clearly one that the IRS would view as falling squarely within the tax shelter orbit. Finally, as I said above, our opinion is only as good as the underlying factual assumptions and actions by the investors. We cannot control with any certainty what they will do in fact!

The way forward. In my view, the technical issues have been worked about as well as they can be. We should decide as a business matter to proceed and work to have in place controls to make sure that the sellers of the transaction and the investors in the transaction do not make a sham of our opinion.

Phil

-----Original Message-----

From: Lanning, John T
Sent: Saturday, May 08, 1999 3:32 PM
To: Ammerman, Douglas K; Wiesner, Philip J
Cc: Stein, Jeff; Lippman, Michael H
Subject: FW: BLIPS

I must say that I am amazed that at this late date (must now be six months into this process) our chief WNT PFP technical expert has reached this conclusion. I would have thought Mark would have been involved on the ground floor of this process, especially on an issue as critical as profit motive. What gives? This appears to be the antithesis of "speed to market". Is there any chance of ever getting this product off the launching pad, or should we simply give up???

John

-----Original Message-----

From: DeLap, Larry
Sent: Friday, May 07, 1999 7:48 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S

3716

Cc: John Lanning; Jeff Stein
Subject: FW: BLIPS

Doug, Jeff, and Randy -

Steve Rosenthal informed me on Tuesday afternoon that he had substantial concern with the "who is the borrower" issuer, and that he would be discussing the matter with Randy on Tuesday or Wednesday. I don't know what the outcome of those discussions were. I imagine Steve would have a concern with the second bullet in Mark Watson's message.

I don't believe a PFP product should be approved when the top PFP technical partner in WNT believes it should not be approved.

I will be back in the U.S. on Saturday and in the Silicon Valley office on Monday morning. Please give me a call on Saturday afternoon or Sunday at home (408-353-3309) or on Monday morning in the office.

Larry

-----Original Message-----

From: Watson, Mark T
Sent: Wednesday, May 05, 1999 9:21 AM
To: Ammerman, Douglas K; Eischeid, Jeffrey A; Bickham, Randall S
Subject: BLIPS

Based on our meeting on April 30 and May 1, I am *not* comfortable with the BLIPS product for the following reasons:

- According to Presidio, the probability of making a profit from this strategy is remote (possible, but remote). Thus, I don't think a client's representation that they thought there was a reasonable opportunity to make a profit is a reasonable representation. If it isn't a reasonable representation, our opinion letter is worthless.
- The bank will control, via a veto power over Presidio, how the "loan" proceeds are invested. Also, it appears that the bank will require this "loan" to be repaid in a relatively short period of time (e.g., 60 days) even though it is structured as a seven-year loan. These factors make it difficult for me to conclude that a bona fide loan was ever made. If a bona-fide loan was not made, the whole transaction falls apart.

Until these issues are resolved satisfactorily, I don't think we should release this product.

Mark T. Watson
Partner
KPMG - Washington National Tax
202-467-2433 (phone)
202-822-8887 (fax)

3717



"Kerry Bratton" <kbratton@presidioadv.com> on 12/28/99 08:47:06 PM

To: Alexandre Nouvakhov/StruFin/NY/NA/Vereinsbank, Amy McCarthy/NY-3/NY/NA/Vereinsbank
cc: "Steven Buss" <sbuss.PO1.Presidio_Domain@presidioadv.com>

Subject: FX Confirmations

I know that Steven has talked to you regarding the error for Roanoke Ventures. I have also noted an error for Mobile Ventures. None of the Euro's should have been converted to USD in 1999. Due to the tax consequences that result from these sales, it is critical that these transactions be reversed and made to look as though they did not occur at all.

I'll give you a call in the AM to discuss.

Thanks
Kerry

Kerry Bratton
Presidio Advisory Services, LLC
Phone: (415) 284-7282
Fax: (415) 284-7284

HVB 002035

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 285

3718

Alexandre Nouvakhov 01/19/2000

To: Matt Dunn/Treasury/NY/NA/Vereinsbank@BV-NA
cc:
Subject: Presidio

Matt,

We need to sell Euros for another Presidio account and credit their USD DDA account. It is the same deal as the one for Roanoke you did earlier today. Sorry for giving piecemeal info, but Presidio told us about this transaction minutes ago. Please confirm when you do the trade and let me know the rate. Thanks.
Alex Nouvakhov

Client Name	Euro Account #	Euro Balance	Euro Rate	Value Date	USD Account #	USD Balance
Mobile Ventures	1781444504	14,800.00		19-Jan-00	1781444502	

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 286

HVB 001601



PFP

To Gregg Ritchie
Warner Center

Date March 2, 1998

From Randall S. Bickham
Palo Alto

Steno ft
Rel c:\windows\temp\~me0d0c
.2

B&W Meeting

For our meeting with R.J. on Wednesday, the suggested agenda is the following items
(John Larson is planning on joining us at 2:00 Wednesday):

1. Update R.J. on our new FCS practice with an emphasis on how the KPMG commitment to building an investment banking practice will benefit B&W. *W*
2. Discuss the implications associated with registering the OPIS product as a tax shelter.
 - a) What is the criteria that is used by others in determining whether to register a tax product?
 - b) Any differentiation between registration criteria for individual versus corporate shelters? *W*
 - c) How will registration impact marketability of product?
 - d) When must decision be made?
 - e) Assuming registration, how can we best use DMG in marketing products? Last year, DMG Technology's first full year of operation, they participated in 28 mergers and acquisitions worth \$14.2 billion.
3. In marketing presentations, what is the ~~KPMG~~ B&W position on the question of protection against imposition of penalties? What does our opinion letter effectively accomplish?
4. Discuss B&W position on whether "co-obligation" constitutes "assumption of liability" in the context of "basis shift" products.
 - a) What other groups have reviewed the Zens product-any problem with the issue?
 - b) What other products does the issue impact-e.g., the Presidio revised 357(c) product?
5. Discuss how to institutionalize the KPMG/ B&W relationship.
 - a) What are the key profit-drivers for our joint practice?
 - i) KPMG- Customer list.
 - ii) KPMG- Financial commitment to invest in the practice in terms of expertising products, hiring franchise players, etc.
 - iii) B&W- Institutional relationships within the investment banking community.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 295

KPMG 0047225

KPMG Peat Marwick LLP

Page 2
 Gregg Ritchie
 Warner Center
 March 3, 1998

- iv) B&W- More panache in closing larger deals where the buyer brings in his Wall Street/D.C. tax advisor.
- b) What should be the profit-split between KPMG, B&W and the tax products group/ implementor for jointly-developed products?
- i) Any formula used should incorporate an initial allocation for the "finder"/ customer list. (The standard finder fee seems to be 10%.)
- ii) For a 7% deal, the following approach is suggested:
- | | | |
|-----------------------------|------------|---|
| Gross Revenue | 700 | |
| Deal Costs | <u>375</u> | |
| Profit | 325 | |
| Finder's allocation | 70 | |
| Net allocated on 1/3 basis- | | |
| KPMG | 85 | } higher than existing profit, I think. |
| B&W | 85 | |
| Implementor | 85 | |
- iii) Accordingly, if KPMG brings the buyer to the table, KPMG would be allocated 155 basis points (70+85). All three JV partners would have joint responsibility for closing the deal.
- c) In deals where B&W acts as a co-venturer, B&W would not be able to write a concurring tax opinion.
- i) What are factors that impact this conclusion- the joint marketing of product, joint development, the form of receiving compensation as a joint venture partner?
- ii) What should be the strategy for selecting the law firm to write the concurring tax opinion?
6. Jointly discuss with John the Presidio Integrated Investment Strategy Program.
- a) The investment analysis presented by Presidio should be institutional-based (e.g., DMG marketing literature) with supporting investment analysis to satisfy an ACM/Colgate type of examination-Investor must have a "reasonable expectation of a reasonable profit".
- i) What needs to be done to finalize the analysis and who is responsible?
- ii) How often will analysis need to be updated?
- b) In addition to demonstrating the reasonable expectation of profitability, the analysis should demonstrate how the use of offshore leverage enhances the Investor's financial return.

Who bears the extra cost?

3721

 Peat Marwick LLP

Page 3
Gregg Ritchie
Warner Center
March 3, 1998

- c) Should an investment prospectus be given to Investor in our initial marketing presentation?

Proprietary Material
Confidentiality Requested

KPMG 0047227

3722

ONE WORLD TRADE CENTER
NEW YORK, N.Y. 10048-0557
TELEPHONE: 212-839-5200
FACSIMILE: 212-839-8595

FEB 26 1997

FACSIMILE COVER SHEET

Please deliver the following pages to:

NAME	COMPANY	FACSIMILE NUMBER
Mr. David Lippman	KPMG Peat Marwick	(212) 872-3311
Mr. John Larson	KPMG Peat Marwick	(415) 951-7270

IF TRANSMISSION IS CONFIDENTIAL TO INDIVIDUAL RECIPIENT, A SEPARATE COVER SHEET IS REQUIRED.

ATTORNEY R.J. Ruble

TELEPHONE 212 839-5573

EIN 1595

DATE February 26, 1997

TIME 3:41 PM

CLIENT/MATTER NO. 70160.00002

NUMBER OF PAGES 32

Grounding this cover sheet

MESSAGE . . .

IN CASE OF TRANSMISSION PROBLEMS, I CAN BE REACHED AT ANY TIME BY TELEPHONE AT 212 839-5573

THIS FACSIMILE CONTAINS CONFIDENTIAL INFORMATION INTENDED ONLY FOR THE USE OF THE PERSON NAMED ABOVE. IF YOU HAVE RECEIVED THIS FACSIMILE IN ERROR, PLEASE NOTIFY US IMMEDIATELY.

LOS ANGELES • SAN FRANCISCO • WASHINGTON
BEIJING • HONG KONG • LONDON • SAO PAULO
TOKYO REPRESENTATIVE OFFICE

TRANSMITTING
OPERATOR: _____

HANDWRITTEN NOTES
HAVE BEEN REDACTED FROM
THIS DOCUMENT

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 301

XX-001440

[Brown & Wood LLP Letterhead]

ATTORNEY-CLIENT
PRIVILEGED AND CONFIDENTIAL

[Address]

Re: Proposed Investment Strategy

Dear []:

You have requested our opinion regarding certain U.S. Federal income tax consequences to a U.S. person ("U.S. Entity") of a proposed transaction described more fully below, whereby U.S. Entity would invest directly and indirectly in stock of a non-U.S. bank ("Foreign Bank") in part through the use of an unrelated foreign investment company ("Investco"). The proposed structure would allow U.S. Entity to make a large investment in Foreign Bank while limiting its risk and avoiding a negative impact to its balance sheet.

Based upon U.S. Entity's review of the pre-tax economics of the proposed transaction, it has concluded that it has a reasonable chance of earning a reasonable pre-tax profit from the proposed transaction, net of associated fees and expenses.

I. The Proposed Transaction

A. Initial Structure

Investco is organized under the laws of the Cayman Islands and is wholly owned by a resident ("Foreign Person") of [country 2]. U.S. Entity will purchase an option or warrant (the "Warrant") from Investco to buy 80% of the then outstanding shares of Investco for a period of one year. The strike price of the Warrant will approximate the current value of such shares of Investco at the time the Warrant is issued.

Investco has purchased shares of Foreign Bank using financing commitments it currently has in place. Neither the Foreign Person nor the Investco will own any Foreign Bank shares other than the shares purchased by Investco. Although Investco anticipates holding the shares of Foreign Bank for a minimum period of 45 days, it is free to dispose of

XX-001441

such shares at any time. Foreign Bank is highly profitable and it is expected that Foreign Bank's earnings and profits for U.S. income tax purposes substantially exceed the value of the shares acquired by Investco.

U.S. Entity will also purchase directly from Foreign Bank 5-10% of the amount of shares purchased by Investco (as described below) which it anticipates holding for at least 90 days. U.S. Entity may desire to hedge its exposure on its Foreign Bank shares and options. To do so, it would sell a portion of the Foreign Bank shares it acquired short and write options with similar terms to the ones it acquired.

In order to hedge against a significant drop in the price of the shares of Foreign Bank, it is expected that Investco will write and sell call options (to Foreign Bank) covering approximately 65% of the Foreign Bank shares Investco owns. Such call options will constitute "qualified covered calls" within the meaning of Section 1092(c) of the Internal Revenue Code of 1986, as amended (the "Code").¹ It is anticipated that at some time in the future, or if the value of the Foreign Bank shares significantly decline, Investco will increase the percentage of call options written. Furthermore, the strike price of the covered calls may be adjusted, depending on price changes, to maintain the effectiveness of the hedge.

In addition to writing call options, Investco will purchase put options [issued by Foreign Bank] covering 100% of the Foreign Bank shares Investco owns at a price that is significantly out-of-the-money as that term is defined in Regulation Section 1.246-5(c)(2). The strike price of the put options may be adjusted, depending on price changes, to maintain the effectiveness of the hedge.

B. Redemption of Shares by Foreign Bank

At such time as is desirable to liquidate its position in Foreign Bank shares, Investco will offer its Foreign Bank shares for redemption by Foreign Bank or for sale on the open market. Such a redemption could also occur through the exercise of the put options held by Investco or upon the exercise of the call options written to [Foreign Bank]. In the event Investco profits from the sale of its Foreign Bank shares, U.S. Entity will either exercise its

¹ All "Section" and "Regulation §" references are to the Code and to the Treasury Regulations promulgated thereunder, respectively.

Warrant or sell such Warrant back to Investco. This action may take place at any time during the life of the Warrant.

Simultaneous with Foreign Bank's redemption of its shares held by Investco, U.S. Entity will purchase out-of-the-money Foreign Bank call options. The options purchased will cover the same number of Investco's Foreign Bank shares redeemed by Foreign Bank. As discussed below, this will assure that the number of Foreign Bank shares deemed to be owned by Investco will remain constant at all times.

U.S. Entity has advised that it believes that, based on past performance, the stock of Foreign Bank will appreciate over the period during which it would exercise the strategy described herein and that the strategy will enable it to capture a meaningful portion of such appreciation. We have been asked to assume such belief is reasonable and is based upon its own independent investigation. U.S. Entity may sell its shares and options at any time at its own discretion. However, it is expected that at least 10% of the Foreign Bank shares acquired by U.S. Entity will be retained as a long term investment. Although U.S. Entity, Foreign Bank and Investco believe that the proposed transaction may occur as discussed above, there is no legally binding agreement, written or otherwise, or economic circumstances that compel any party to participate in these transactions in the manner described herein.

II. Summary

In rendering our opinion, we have reviewed representations and advice from various parties to the Transactions, which representations and advice are referred to herein. We have made no independent verification of such representation or advice, and if any such representations or advice is inaccurate in any material respect, the opinions contained herein may not be relied upon. Lastly, in rendering our opinion, we have reviewed the applicable provisions of the Internal Revenue Code of 1986, as amended ("Code") and of the final, temporary, and proposed Treasury Regulations ("Treas. Reg." or "Treasury Regulations") promulgated thereunder; relevant decisions of the U.S. federal courts; published Revenue Rulings ("Rev. Rul.") and Revenue Procedures ("Rev. Proc.") of the Internal Revenue Service; and such other materials as we have considered relevant. In certain instances we have determined that there is no authority directly on point, and in such instances we have

reached an opinion reasoning from such other authority as we believe to be relevant to the issues addressed.

Based on the facts presented, the advice given to us, the assumptions we have been asked to make, and the legal analysis below, and assuming that the proposed transactions occur as anticipated, we are of the opinion that under current U.S. Federal income tax law, it is more likely than not that: (i) U.S. Entity will have a tax basis in the shares of Foreign Bank stock it retains equal to U.S. Entity's initial tax basis in such shares plus an amount equal to Investco's tax basis in the shares of Foreign Bank stock redeemed from Investco by Foreign Bank; and (ii) any loss U.S. Entity might recognize upon its ultimate disposition of Foreign Bank stock under current law will be treated as derived from U.S. sources.

III. Legal Analysis

A. Dividend Treatment of the Redemption of Investco's Foreign Bank Shares

1. Provisions of Section 302². Section 302 governs the treatment of amounts received by a shareholder from a corporation in redemption of the corporation's own stock. In general, such amounts are treated as a distribution in part or full payment in exchange for such stock if the redemption meets one of four tests set forth in Section 302(b). If the redemption fails to meet such tests, Section 302(d) provides that such redemption is treated as a distribution of property to which Section 301 applies. If the redemption is treated as a distribution under Section 302(d), amounts received by the shareholder will be treated as a dividend, and taxable as ordinary income, to the extent of the earnings and profits of the redeeming corporation.

The requirements under Section 302(b) for sale or exchange treatment are: (1) the redemption that is "not essentially equivalent to a dividend," (2) the redemption from a noncorporate shareholder in partial liquidation of the corporation³, (3) the redemption is a

² Unless otherwise provided, all references are to the Code and Treasury Regulations.

³ Because U.S. Entity is not a non-corporate shareholder, this test is irrelevant in the instant case.

"substantially disproportionate" redemption of stock, or (4) the redemption which completely terminates a shareholder's interest in the corporation.

2. Stock ownership attribution rules of Section 318. Section 302(c) provides that in determining whether a redemption qualifies for sale or exchange treatment under Code Section 302(b), the stock ownership attribution rules of Section 318 apply. Under Section 318(a)(3)(C), a corporation is deemed to own all stock owned directly or indirectly by any person that owns 50% or more of the value of its stock. Section 318(a)(4) provides that a person that owns an option to acquire stock shall be considered as owning such stock. Revenue Ruling 68-601, 1968-2 C.B. 124, states that warrants are options within the meaning of Section 318(a)(4) and must be taken into consideration in determining whether a redemption qualifies as substantially disproportionate within the meaning of Section 302(b)(2). Revenue Ruling 89-64, 1989-1 C.B. 91, further clarifies Revenue Ruling 68-601, stating that an option constitutes an option for purposes of Section 318(a)(4), even though it is only exercisable after a period of time has lapsed. Lastly, Section 318(a)(5)(A) provides that, with certain exceptions not relevant in the instant case, stock deemed owned by someone under the Section 318 attribution rules is actually owned by that person and may be reattributed to another person under those rules.

3. Application Sections 302 and 318 to the Proposed Transaction. Under Section 318(a)(4) U.S. Entity is treated as actually owning the Investco shares that U.S. Entity has a right to acquire from Foreign Person under the Warrant. Consequently, U.S. Entity will be deemed to own through the Warrant 80% of the Investco shares.

Under Section 318(a)(3)(C), because U.S. Entity is deemed to own 80% of the Investco shares, Investco is deemed to own all of the Foreign Bank shares that U.S. Entity actually owns and which U.S. Entity is treated as owning under Code Section 318(a)(4) through its acquisition of out-of-the-money Foreign Bank call options. In addition, under Code Section 318(a)(4) Investco will be treated as actually owning the same number of Foreign Bank shares it has options to acquire. Consequently, through application of the Code Section 318 attribution rules discussed above, Investco will own or be deemed to own at least as many shares of Foreign Bank's stock as the number redeemed by Foreign Bank from Investco.

Because, by application of the Code Section 318 attribution rules, there will be no reduction in the Investco's percentage ownership of Foreign Bank after the redemption of the Foreign Bank shares actually owned by Investco, the redemption cannot qualify as a complete termination of Investco's interest in Foreign Bank. See, Code Section 302(b)(3). Moreover, it precludes the redemption from qualifying as an exchange under any of the other pertinent tests in Section 302(b). See, Section 302(b)(1), (2) and (3). Consequently, it is more likely than not that the redemption by Foreign Bank of its shares from Investco therefore will be treated for U.S. Federal income tax purposes as a distribution from Foreign Bank to Investco that will be treated as a dividend under Section 301, assuming sufficient earnings and profits from Foreign Bank.

This conclusion is confirmed by U.S. v. Davis (397 U.S. 301 (1970)).⁴ In Davis the Supreme Court held that the Code Section 318 attribution rules must be applied, specifically to a Section 302(b)(1) issue (redemption not essentially equivalent to a dividend). The Court determined that attribution clearly applies to Sections 302(b)(2) and (3) situations (redemption is substantially disproportionate or complete termination of interest). Significantly, Davis goes on to hold that the presence or absence of a tax avoidance motive should not be considered when evaluating a redemption against the objective standards of Section 302(b)(1). This should also hold true for other types of redemptions. The Internal Revenue Service ("IRS") has cited Davis in a number of rulings including Revenue Ruling 80-26 and 81-289, signifying their agreement with its holdings.

B. Increase in U.S. Entity's Basis in Foreign Bank Stock

Although after the redemption of the Foreign Bank it actually owned Investco will be deemed to own under the Code Section 318 attributable rule Foreign Bank shares actually and constructively owned by U.S. Entity, after the redemption, it will own no Foreign Bank

⁴ Notwithstanding the Davis decision, in Robin Haft Trust, et al., v. Commissioner, 510 F.2d 43 (1st Cir. 1973), rev'd and remanding 61 T.C. 393 (1973), supplemented, 62 T.C. 145 (1974), the court held that the rules attributing stock ownership among family members can be disregarded in testing the redemption of the taxpayers' stock for dividend equivalency because of family hostility. The court reasoned that the attribution rules had a presumption of continuing influence over corporate affairs, and accordingly, family discord negated the presumption. However, in Revenue Ruling 80-26, 1980-1 C.B. 66, the IRS ruled that it will not follow the decision in Haft. In addition, the instant situation is factually distinguishable from Haft, because Haft was limited to the application of attribution among family members, a situation that does not exist in the instant case.

shares directly. Because it is more likely than not that the redemption of Investco's Foreign Bank shares will be treated as a distribution for U.S. tax purposes, pursuant to which the entire amount of redemption proceeds will be treated as a dividend, Investco's tax basis in the redeemed Foreign Bank shares must be accounted for in some manner.

Treas. Reg. § 1.302-2(c) provides that when stock is redeemed in a deemed distribution, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." However, where the redeemed taxpayer holds no remaining stock directly, such basis adjustment will apply to the stock which was treated as indirectly held by the taxpayer under the attribution rules. This result is confirmed under example 2 of such regulation which states that when Husband and Wife each own 50% of the stock of Corporation and Husband's entire direct holding is redeemed by Corporation in a deemed distribution, the basis of Husband's redeemed shares is added to Wife's basis in her shares of Corporation.

At least one court, in dictum, has recognized the validity of this approach. In Levin v. Commissioner, 385 F.2d 521 (2d Cir. 1967), the Second Circuit held that a complete redemption of the taxpayer's directly-owned stock in a closely-held corporation was a deemed distribution under Section 302(d) because the shares owned by the taxpayer's son were deemed owned by her under Section 318. Among other things, the taxpayer argued that this treatment caused her basis in the stock to disappear, resulting in an unconstitutional direct tax. The court rejected this argument, noting that the taxpayer's basis did not disappear but was added to her son's basis pursuant to Treas. Reg. § 1.302-2(c). Levin, at 528, n.29.⁵

⁵ Commentators also have endorsed this approach. Professors Binker and Eustice have observed that:

"[i]f the shareholder retains no shares after the redemption, the regulations sanction a transfer of the basis to the shares of a related taxpayer, at least if those shares were attributed to the redeemed shareholder and were, therefore, responsible for the seller's inability to offset the basis of the redeemed Shares against the amount received for them. Ordinarily, the transfer of the redeemed shareholder's basis to shares owned by a related person is a reasonable adjustment."

B. Binker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, 6th ed., at §9.22[2] (footnotes omitted).

(continued...)

In the proposed transaction, based on advice received from Investco and its shareholders, U.S. Entity will be the only person related to Investco that will own Foreign Bank shares and whose shares would be attributed to Investco. Based on the foregoing authority, it is more likely than not that Investco's basis in its redeemed Foreign Bank stock is properly allocable to U.S. Entity's Foreign Bank shares.

Because U.S. Entity owns both shares and options in Foreign Bank, however, it is unclear if all of the basis in the redeemed shares is allocated solely to the Foreign Bank shares owned by U.S. Entity or if any of the additional basis must be allocated to the options, although a literal reading of Treas. Reg. § 1.302-2(c) indicates the basis gets allocated solely to Foreign Bank shares directly owned by U.S. Entity. Despite the literal reading of the Regulations, it is possible that a portion of Investco's basis could be allocated to U.S. Entity's options in Foreign Bank as well. Treas. Reg. § 1.61-6 provides that when a taxpayer disposes of property that is part of a greater whole, the basis of the whole is allocated between the part sold and the part retained in proportion to their relative fair market values. Consequently, it is arguable that U.S. Entity should allocate the basis arising from Investco's redeemed Foreign Bank stock between Foreign Bank shares actually owned by U.S. Entity and its options for shares based on the relative fair market values of those two holdings.

C. Inapplicability of Other Tax Provisions and Legal Doctrines

In arriving at our conclusion, we have considered several other Code provisions, as well as certain judicial doctrine which, if applicable, could impact upon the tax results of this transaction.

1. Investco Should be Treated as a Shareholder of Foreign Bank under Statutory Authority. As noted above, Investco anticipates that it will write qualified covered call options for a portion of the shares held in Foreign Bank. In addition, it is anticipated that Investco will purchase significantly out-of-the-money put options for as much as 100% of the

⁵(...continued)

Compare: Rev. Rul. 70-496, 1970-2 C.B. 74, in which the IRS refused to attribute the tax basis in the redeemed shares to shares owned by a related party in the context of Code Section 304 transaction. This result appears to be limited to transactions subject to Code Section 304, which does not apply to the instant case. See, PLR 8327091 (4/8/83).

800772/00467.2

Foreign Bank shares it holds. Because Investco has effectively limited a portion of the benefits and risks of owning unhedged Foreign Bank shares, issues may arise relating to Investco's ownership of such shares for U.S. tax purposes.

For U.S. Federal income tax purposes, ownership of an asset is dependent not only upon legal title to the assets, but on the economic incidents of ownership, i.e. who has the economic benefits and burdens associated with ownership of the asset. This issue, and authorities addressing it, arise in a number of contexts, including the sale-leaseback of real and personal property, the ownership of municipal bonds subject to repurchase agreements or put options, and the pledge of installment obligations.

One useful analogy to examine, because the rules are relatively clearly laid out in Treasury Regulations, is the dividends received deduction ("DRD") of Section 243. These rules limit the ability of a taxpayer to claim the benefits of such deduction if the taxpayer's risk of loss is sufficiently circumscribed. It should be noted that the DRD does not deny ownership of the stock for other purposes. Thus, we believe that if Investco's interest in the Foreign Bank shares could pass muster for DRD purposes, it is more likely than not that Investco will be deemed to own the stock for other purposes of the Code.

Section 246(c) denies the benefits of the dividends received deduction to corporate shareholders that hold stock of another corporation for 45 days or less and receive a dividend from that corporation with respect to the stock. The use of a 45 day holding period as a condition for allowing the dividends received deduction indicates the view of Congress that a shareholder constitutes the true owner of stock for DRD purposes when it has held such stock for 45 days. By analogy, it is not unreasonable to conclude that Investco should be treated as the true owner of Foreign Bank shares if Investco's position with respect to the Foreign Bank shares would satisfy the 45 day holding period of Section 246.

Regulation Section 1.246-5 addresses whether a shareholder has entered into arrangements sufficiently diminishing its risk of loss on its share holdings that it should not be considered to hold the stock for purpose of calculating the 45 day period. Specifically, such Regulation reduces the 45 day holding period for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property. A taxpayer has a diminished risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the

fair market values of the stock and the positions are reasonably expected to vary inversely. If Investco has diminished its risk of loss on its Foreign Bank position in the manner described in Section 246(c)(4) and Regulation Section 1.246-5, it is arguable that Investco would not be treated as the owner of the Foreign Bank shares for U.S. tax purposes.

For purposes of the DRD, a taxpayer that sells options to buy its stock holdings has diminished its risk of loss on such stock unless the option to buy written constitutes a "qualified covered call." In addition, a taxpayer that acquires options to sell stock has diminished its risk of loss on such stock unless the option is significantly out-of-the-money and is not held as part of a strategy to substantially offset changes in the fair market value of the stock.

A qualified covered call, for purposes of Section 246(c)(4), is defined as a call option which is: i) listed on an established securities market; ii) granted for more than 30 days; and iii) not deep-in-the-money at the time of issuance. Established securities markets will generally include a foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934. Regulation Section §1.1092(d)(1)(b)(1)(iv).

Section 1092(c)(4)(C) provides that deep-in-the-money means an option having a strike price lower than the lowest qualified benchmark. For example, if options on Foreign Bank shares could be written in 5 dollar increments, shares selling for forty (40) dollars will have options with strike prices of thirty-five (35), forty (40), and forty-five (45) dollars. The lowest qualified benchmark for options written for a period of not more than ninety days is generally the highest strike price which is less than the stock price. For example, when the stock price is forty-two (42) dollars, a less than ninety day option written with a strike price of forty (40) dollars or more would be a qualified covered call but an option with a strike price of thirty-five (35) dollars would not.

The lowest qualified benchmark for options written for a period of more than ninety (90) days, where the stock price is more than fifty (50) dollars is generally the second highest strike price which is less than the stock price. For example, if the stock price were sixty-two (62) dollars, then a more than ninety day option written with a strike price of fifty-five (55) dollars or more would be a qualified covered call. Investco has represented that it will only sell qualified covered calls.

Generally, a put option is considered significantly out-of-the-money if it is at least one benchmark below the price of the stock. For Foreign Bank shares, one benchmark would be five (5) dollars. For instance, if the stock is selling at fifty-two (52) dollars, an option at forty-five (45) dollars will be considered significantly out-of-the-money.

On May 27, 1993 the Treasury issued Proposed Regulation Section 1.246-5. In the preamble to Proposed Regulation 1.246-5, the Treasury indicated that whether a taxpayer has diminished its risk of loss on stock by holding an option depends on the degree of risk protection that option affords. Specifically, Proposed Regulation Section 1.246-5(b)(3) provides that "an option diminishes the taxpayer's risk of loss on its stock if decreases in the fair market value of the stock are expected to be offset substantially by increases in the fair market value of the option." Generally this will only occur when an option is in-the-money. Proposed Regulation Section 1.246-5 goes on to state that options to sell that are significantly out-of-the-money will not diminish the taxpayer's risk of loss on its stock.

On May 17, 1995, the Treasury finalized Treas. Reg. § 1.246-5. The final regulations removed the language requiring "decreases in the fair market value of the stock are expected to be offset substantially by increases in the fair market value of the option," however, maintained the language that "an option that is significantly out-of-the-money does not diminish the taxpayer's risk of loss on its stock." Treas. Reg. § 1.246-5(c)(2) did add one other caveat, i.e., where an out-of-the-money option is held as part of a strategy to substantially offset changes in the fair market value of the stock, the Treasury can consider that option to reduce the Taxpayer's risk. Although Treasury has indicated that each determination should be made on a case-by-case basis, there is no authority that addresses what constitutes such a strategy.

Prior to the issuance of Treas. Reg. § 1.246-5(c)(2), the IRS has held in Rev. Rul. 80-238 that where the taxpayer is not in a risk free position, or where the element of risk is not greatly reduced or eliminated, the DRD holding period should not be reduced. This should be contrasted to a risk free position should be such that the taxpayer has guaranteed himself against risk of loss. For example, if the taxpayer were to write a call option and sell a put ("forward conversion") at the same strike price, regardless of the movement of the stock, the taxpayer would be protected against loss. Essentially, the call and put options would function as a synthetic short position and insulate the long position, much the same as a short-against-the-box transaction. See, *Progressive Corporation v. U.S.*, 970 F.2d 138 (6th

Cir. 1992); holding period reduced for purposes of DRD during the period that the taxpayer held forward conversions on shares of stock where dividends were paid. See also, Kwajit v. Comm'r. T.C. Memo. 1992-433. However, where the taxpayer purchases an out-of-the-money option to sell, without writing a call option with the same strike price, a degree of risk exists such that the taxpayer can suffer loss and the holding period should not be reduced.

Investco has represented that it will only hedge its Foreign Bank position by writing qualified covered calls and purchasing out-of-the-money puts. It is anticipated that Investco will hold the Foreign Bank stock for more than 45 days. Accordingly, were one determining Investco's holding period under the DRD rules, it is more likely than not that Investco's holding period would not be tolled by its hedges because it is not anticipated that the hedges will fall within the definition of a diminished risk of loss as set forth in Section 246 in conjunction with the definitions set out in Section 1092 or the regulations thereunder relating to qualified covered calls and significantly out-of-the-money put options. Moreover, because of the real opportunity for loss, it is more likely than not that Investco's hedging arrangement would not be viewed as part of a strategy to substantially offset changes in the fair market value of Foreign Bank stock. Thus, it is more than likely than not that Investco's holding period in the Foreign Bank shares would not be diminished for purposes of the DRD. Consequently it is more likely than not that Investco would be treated as the owner of such shares for purposes of the Code generally.

2. Application of the Step Transaction Doctrine. The step-transaction doctrine is an analytical framework which the courts have used to determine the substance of a series of transactions undertaken by a taxpayer. As articulated by the Tax Court, the step-transaction doctrine "treats a series of formally separate 'steps' as a single transaction if such steps are in substance, integrated, interdependent, and focused toward a particular result." Esauark, Inc. v. Comm'r. 90 T.C. 171, 195 (1988), aff'd without published opinion, 886 F.2d 1218 (7th Cir. 1989).

Although there is general agreement regarding the existence of the step-transaction doctrine, its application by the courts has not been altogether uniform, and three basic formulations of the doctrine have been developed. These are the "binding commitment", the "mutual independence", and the "end result" formulations. See, Penrod v. Comm'r. 88 T.C. 1415, 1429 (1987).

The "binding commitment" formulation requires the integration of a series of transactions only if there is a binding legal commitment to undertake each of the steps. See Comm'r v. Gordon, 391 U.S. 83, 96 (1968). As discussed above, there will be no formal agreements among any of the parties to undertake any of steps in the proposed transaction. Consequently, it is more likely than not that the binding commitment formulation of the step transaction doctrine will not be applicable to the transactions summarized herein.

The "mutual interdependence" formulation requires the integration of a series of transactions only if each is so interdependent on the others that the legal relationships created by each step is fruitless without the completion of the series. Redding v. Comm'r, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied 450 U.S. 913 (1981). See also, Dyess v. Comm'r, T.C. Memo. 1993-219. It should be noted that the tenth Circuit Court of Appeals recently has applied the "mutual interdependence" formulation of the step transaction doctrine to integrate two purportedly independent transactions in Associated Wholesale Grocers, Inc. v. U.S., 927 F.2d 1517 (10th Cir. 1991). Unlike the factual situation in Associated Wholesale Grocers, none of the agreements among the various parties in the instant case will be dependent upon the effectiveness of any of the other agreements. Furthermore, although the various contemplated transactions could occur within a relatively short period of time, each of the transactions contemplated by the parties will present the parties with the potential for economic gain and risk. It should also be noted that while generally adopting the criteria of Redding v. Comm'r, *supra*, in stating its view of the "mutual interdependence" formulation, the IRS has added an additional criterion, i.e., that each step be undertaken for a valid business reason. See, Rev. Rul. 79-250, 1979-2 C.B. 256. This criterion was not espoused by the Court in Redding, and no subsequent decision has cited Rev. Rul. 79-250 in articulating its position in the application of the step-transaction doctrine.

Based upon the Redding decision, it is more likely than not that each step undertaken by the parties to the summarized transactions will be viewed as independent from the others and, consequently, it is more likely than not that the "mutual interdependence" formulation of the step transaction doctrine will not be applicable to the Transactions. Furthermore, even if a court were to adopt the position of the IRS in Rev. Rul. 79-250, each of the contemplated actions by the parties is supported by their reasonable expectation of profit regardless of whether Foreign Bank ultimately redeems its shares held by Investco.

The "end-result" formulation integrates a series of transactions into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be undertaken for the purpose of reaching an ultimate result. King Enterprises, Inc. v. U.S., 418 F.2d 511, 516 (Ct.Cl. 1969). See also, Blake v. Comm'r., 697 F.2d 473 (2d Cir. 1982). Notwithstanding the seemingly broad scope of the end-result formulation, the courts have recognized a significant limitation on its application. This was recently articulated by the Tax Court in Esmark, Inc. v. Comm'r., *supra*, wherein the court stated: "[The IRS's] recharacterization does not simply combine steps; it invents new ones. Courts have refused to apply the step-transaction doctrine in this manner." 90 T.C. at 196. In support of its conclusion, the Tax Court cited, among a number of other cases, Grove v. Comm'r., 490 F.2d 241 (2d Cir. 1973), *aff'd*, T.C.Memo. 1972-98.

The Esmark case is of particular relevance in the instant case. In Esmark, the taxpayer desired to dispose of certain unwanted businesses. The taxpayer and its advisors formulated a plan to contract its capital structure through a redemption of its outstanding shares by having a third party tender for a portion of the taxpayer's outstanding shares and then tender the acquired shares for an asset, stock of a wholly-owned subsidiary, of the taxpayer. In addition to achieving the desired business results, the proposal was tax efficient, because, under law as then in effect, the exchange of its subsidiary's stock for its outstanding shares would have been tax free to the taxpayer, whereas a sale of the subsidiary's stock for cash, which cash could then have been used for a self-tender, would have produced a taxable transaction.

Concluding that the step-transaction doctrine could not be applied to so recast the transaction, the Tax Court still recognized that the reduction of taxes was a significant factor in structuring the transaction and that Mobil's tender offer was part of an overall plan. The Court also recognized that Mobil, not the taxpayer, had borne the economic cost of the tender offer and that Mobil's ownership of the Esmark shares, "however transitory", must be respected. 90 T.C. at 198.

The National Office of the IRS has also recognized the premise of the Esmark case, i.e., that the step-transaction does not permit the creation of new steps or the reordering of existing steps, in a series of four Technical Advice Memoranda. See PLR 8815003, PLR 8738003, and PLR 8735006. Each involves the acquisition of a corporation's outstanding debt by an unrelated underwriter, the exchange of debt for other securities of the

corporation, and the sale of such other securities by the underwriter to the public. In each case, the Technical Advice Memoranda concluded that the end result formulation does not require that the transactions be stepped together.

To be contrasted to the Esmark case are the more recent cases, Salomon Inc. v. U.S., supra, and Walt Disney Inc. v. U.S., 4 F.3d 735 (5th Cir. 1993), rev'd 97 T.C. 221 (1991). Both cases involved the issue of whether there had been a disposition of assets that would trigger investment credit recapture under Code Section 47(s)(1). Both cases involved similar divisive "D" reorganizations in which assets were transferred to a subsidiary and the shares of the subsidiary were spun off to the shareholders of the parent corporation. Although both courts claimed to apply the "end result" formulation in order to integrate the drop-down and spin-off, facts were present which were much closer to the facts found in "binding commitment" and "mutual independence" cases. In Walt Disney Inc., the Court reached its conclusion on overall intention for the steps to occur, plus the existence of a binding agreement which "manifests" such intent and which overcame the fact that the transactions were separated by a 59 day period of time during which the parent company was at risk with respect to the transferred assets. In Salomon, the court based its conclusion on an overall intention for the steps to occur which was supported by the statements regarding the integration of the steps to the IRS in the ruling request and the fact that the spin-off occurred immediately after the drop-down.

In the proposed transaction, both U.S. Entity and Investco have placed themselves at risk with respect to the Foreign Bank shares. U.S. Entity bears the risk that the shares of Foreign Bank it holds will decline in value and that the value of Investco stock will render the options it acquires worthless. The parties anticipate holding the investments for periods ranging from 46 to 90 days at a minimum. Although Investco anticipates hedging its risk by writing call options and purchasing puts, we have been advised that such hedges will not completely offset any losses of Investco upon a decline in the value of Foreign Bank shares. Furthermore, because the calls written by Investco are not "in-the-money," Investco has a real possibility of gaining upon any appreciation in value of Foreign Bank stock. Furthermore, there is no binding commitment to complete the transactions as contemplated, nor is it expected that all event will occur within a short period of time, if at all. Based on the factual distinctions from the Walt Disney Inc. and Salomon Inc. cases, and on the decision of the Tax Court in the Esmark case, it is more likely than not that the "end-result" formulation of the step-transaction doctrine will not apply to the Transactions.

3. Application of the Agency Doctrine. Like the step transaction doctrine, the agency doctrine operates to recast a transaction's substance in a manner different from its form, thereby altering its tax effects. Application of the agency doctrine to the proposed transaction would treat the Investco as U.S. Entity's agent in effecting the various transactions. Thus, U.S. Entity would be viewed as the true owner of the Foreign Bank stock purchased by Investco, and would either be deemed to have disposed of all of its Foreign Bank stock in a single transaction, resulting in no net tax effect to it, or to have received the dividend that Foreign Bank would receive were the form of the transaction respected.

Whether any of the parties to the proposed transaction are the agent of another for Federal income tax purposes depends whether each is acting for its own account. J.H. Baird Publishing Co. v. Comm'r. 39 T.C. 608 (1968), acq. 1963-2 C.B.4. This is to be gleaned both from the contractual arrangements, if any, between the parties and from the economic substance of their relationship. J.H. Baird Publishing Co. v. Comm'r. *supra*.

In the instant case there is no contractual relationship between any of the parties relating to effecting the proposed transaction and there appears to be no legal basis on which a third party could look to any other party for specific damages or performance with respect to any contract entered into between the third party and a particular participant with respect to the proposed transactions.

Likewise, in the instant case, the economic risk from the lack of performance by each in connection with the proposed transaction will fall solely upon it and not upon the other. Although each will attempt to limit, to the extent possible, its economic risk, the economic burden of its failure to do so will fall solely upon it. Such a position is incompatible with an agency relationship. See, J.H. Baird Publishing Co. v. Comm'r., *supra*; Congress Square Hotel Co. v. Comm'r., 4 T.C. 775 (1945), acq. 1945 C.B.2; Warner Co. v. Comm'r., 11 T.C. 419 (1948), *aff'd per curiam*, 181 F.2d 599 (3d Cir. 1950); American Business Credit Corp. v. Comm'r., 9 T.C. 1111 (1947), acq. 1948-1 C.B.1. Ct. Esmark, Inc. v. Comm'r., 90 T.C. 171 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989).

In addition, at least two Supreme Court cases have considered whether an agency relationship existed and affected the tax results of transactions. In Commissioner v. Bollinger, 485 U.S. 340 (1988), the taxpayer, individually and through several partnerships, was engaged in rental real estate development. State usury law limited the rate of interest that

could be charged to non-corporate debtors, so the taxpayer, at the lenders' behest, formed a wholly-owned corporation to be the nominal borrower. The corporation held legal title to the developed projects pursuant to written agency agreements with the taxpayer, and the taxpayer and the partnerships held themselves out to the lenders as the principals. Moreover, the corporate agent had no assets, liabilities, employees, or bank accounts; it merely forwarded loan proceeds to the partnership on whose behalf it had obtained a loan. The partnerships actively managed the properties and reported the income and losses generated by the developments on their partnership tax returns.

The Supreme Court, applying the six-part National Carbide test, rejected the IRS's contention that the corporation was the true owners of the real estate developments and held that the corporation was a bona fide agent of the taxpayer and the partnerships. More specifically, the Court found that the agency relationship was adequately established in this case because (1) it was set forth in a written agreement at the time each development was begun; (2) the corporation acted as agent and not as principal with respect to all the developments for all purposes; and (3) the corporation was held out as the agent and not the principal in all dealings with third parties with respect to all the developments.

In Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991), the taxpayer was a savings and loan association which, in the early 1980's, had large unrealized losses from its portfolio of long-term, low-interest home mortgages. Due to regulatory constraints, the taxpayer could not sell the loans without running the risk that the resulting losses would force its regulator to close it. Instead, the taxpayer's regulator proposed that the taxpayer and other savings and loans trade participations in various mortgages in their loan portfolios with the idea that such trades would be treated as recognition events for Federal income tax purposes. The taxpayer therefore traded a package of participation interests in its loan portfolio for similar interests in portfolios of four other savings and loans.

The IRS argued that such trades were not tax recognition events because, among other things, they had no economic effect. In other words, the IRS appeared to argue that the taxpayer's counterparties to the trade were merely acting as its agents, with the result that the taxpayer retained de facto ownership in the interests. The Supreme Court rejected this argument and held that the trades did have economic effect because (1) there was no evidence that the parties had acted other than at arm's length and (2) the taxpayer had not retained de facto ownership. It reasoned that because the mortgages traded involved different

mortgagors and different properties securing the mortgages, there was an exchange of legally distinct properties giving rise to a true economic event for tax purposes.

In the proposed transaction, Investco is economically at risk with respect to its position in Foreign Bank stock, and there are no formal indications of a principal-agent relationship in place, i.e., the parties will act independently of each other, there will be no written agency agreements, and no party will hold itself out to third parties as an agent of the others and no party has the legal ability to bind another party by its actions. Furthermore, the purchase prices paid by the parties will reflect arm's length transactions and the proposed transactions have separate legal and economic significance, in part due to the economic interests in Investco of Foreign Person, an unrelated person who owns all of the stock of Investco. Although the acquisition price paid by Investco for its significant amount of Foreign Bank stock over an admittedly short period of time may cause Investco to pay a greater amount than the current per share price of Foreign Bank, U.S. Entity is not obligated in any way to compensate Investco, Foreign Person or Foreign Bank for this risk or for any other costs incurred by Foreign Bank or Investco. Moreover, any additional gain Investco realizes from the transaction will be for it to keep. Thus, it is more likely than not that the IRS would be unsuccessful were it to attempt to assert the agency doctrine in the circumstances.

4. Sham Transaction Doctrine. If a transaction is entered into for no other purpose or effect other than the reduction of taxes, it will constitute a sham transaction and will not be respected for tax purposes. As discussed below, if a transaction has a substantial business purpose and economic substance it will be respected, regardless of a taxpayer's additional motive of reducing taxes.

In Frank Lyon Co. v. United States, 435 U.S. 561, 583-584 (1978), the Supreme Court concluded that the tax benefits of a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities should not be disregarded where the transaction was not shaped solely by tax-avoidance features that have meaningless labels attached.

After Lyon, the courts created a two-part test to determine whether a transaction should be disregarded as a sham. In order for a transaction to be disregarded, "the court must find that the taxpayer was motivated by no business purpose other than obtaining tax

benefits in entering into the transaction, and that the transaction has no economic substance because no possibility of profit exists." Rice's Toyota World v. Commissioner, 732 F.2d 89, 91 (4th Cir. 1985), aff'd 81 T.C. 184 (1983). Although the test laid down in Rice's Toyota World is a two-part test, taxpayers typically have been unsuccessful in merely showing that a transaction had some business purpose where the transaction lacked economic substance. In general, the courts have looked to see whether a transaction had a reasonable profit potential, if it generally was not struck down.

As noted above, U.S. Entity has represented that a review of the net pre-tax underlying economics of the transaction leads it to conclude that it has a reasonable chance to earn a reasonable profit from the transactions described herein. In addition, both the Inverco and U.S. Entity each have a reasonable possibility of making a reasonable economic profit (or loss) from their holdings of the Foreign Bank stock. Therefore, the transaction should not be struck down as a sham.

Despite being inconsistent with the bulk of sham transaction cases, one case has indicated that there must be not only a reasonable chance of making a profit, but the chance must relate to a reasonable profit. See Sheldon v. Commissioner, 94 T.C. 738 (1990). Yet, the present facts indicate that this standard would also be met. Again, U.S. Entity has represented that it believes that it has a reasonable chance to earn a reasonable profit from the transactions described herein, in excess of all associated fees and costs and not including any tax benefits that may occur.

Although at least two courts have indicated that they would consider applying the sham transaction doctrine unless the profit motive was greater than the tax motive, such approach would be inconsistent with other areas of tax law requiring a business purpose. See Fox v. Commissioner, 82 T.C. 1001 (1994) and Estate of Baron v. Commissioner, 83 T.C. 542 (1984), aff'd, 798 F.2d 65 (2d Cir. 1986). Accordingly, we believe that under the present state of the law, it is more likely than not that the sham transaction doctrine will not apply if Inverco has a reasonable chance of making a reasonable profit.

5. Application of Section 269. Section 269 grants the IRS broad power to deny taxpayers the benefit of any deduction, credit, or other allowance when such benefit is secured through the acquisition, directly or indirectly, of control of a corporation. The IRS must prove that the principal purpose of the acquisition was to evade or avoid Federal

income tax by securing such benefit. Section 269 could prevent U.S. Entity from acceding to Investco's basis in its redeemed Foreign Bank stock if U.S. Entity acquired control of Investco through exercise of the Investco option and such acquisition was made for the primary purpose of securing the benefit of an increased basis in its Foreign Bank stock.

Section 269 does not appear to apply to these transactions because the transaction does not involve the acquisition or control of a corporation. The flush language of Section 269(a) states that "control means the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote or at least 50% of the total value of shares of all classes of stock of the corporation." Regulation Section 1.269-1(c) contains the same definition. We have been advised that Foreign Person previously required direct ownership of Investco shares in a transaction that was independent from those involving U.S. Entity, and although U.S. Entity will own options on Investco's stock permitting it to acquire control of Investco, unless exercised, it will not actually own any stock of Investco. Furthermore, unlike Section 302 which deems such options exercised, there is no corresponding provision deeming their exercise for purposes of Section 269. Therefore, provided U.S. Entity does not exercise its option to acquire Investco stock, it will not acquire control of Investco within the meaning of Section 269 at any time and Section 269, by its own terms, would not apply to the proposed transaction.

6. Applicability of Section 1059 - Adjustments to Basis for Extraordinary Dividends. Under Section 1059, a corporate shareholder must reduce the basis of stock they hold in other corporations by the "nontaxed portion" of any "extraordinary dividends" paid thereon.⁴ Accordingly, if the redemption of Investco's Foreign Bank shares is considered to be a distribution to Investco that is an extraordinary dividend under Section 1059, there is a risk that U.S. Entity might not be able to increase the basis of its own Foreign Bank shares by the amount of the basis of Investco in its redeemed Foreign Bank shares. For purposes of this discussion, it is assumed that the distribution to Investco will constitute an "extraordinary dividend."

⁴ Under Code Section 1059(a)(1), the payee does not reduce basis below zero. However, the payee must recognize gain on a subsequent disposition of stock upon which an extraordinary dividend has been paid to the extent this limitation prevents reduction of basis. Code Section 1059(a)(2).

Section 1059 does not apply, however, if there is no "nontaxed portion" of the dividend received by Investco. The "nontaxed portion" is the excess, if any, of the amount of such dividend over the "taxable portion" of such dividend, and the "taxable portion" is the portion of such dividend includible in gross income, reduced by the amount of any dividends received deduction of Sections 243, 244, and 245. In the proposed transaction, because Investco is a foreign corporation, it will not qualify for the dividends received deduction of Sections 243, 244, or 245. Accordingly, the taxable portion of the dividend will be the entire amount of the dividend included in Investco's gross income.

Section 1059 itself contains no indication of how the gross income of a foreign corporation, such as Investco, should be defined or calculated, nor do the proposed Treasury Regulations issued thereunder. Because Section 1059 provides no explicit guidance as to the definition of "gross income" it is necessary to turn to other areas of the Code to determine the phrase's meaning. In general, the determination of gross income is made by reference to Section 61. Section 61 states that, "*except otherwise provided in this subtitle, gross income means all income from whatever source derived ...*" (italics added). This would include dividend income from any source as well as most other types of income. However, in the case of foreign corporations, other narrower definitions of gross income are provided elsewhere in the Code. Because Investco is a foreign corporation it is necessary to determine which, if any, of several possible definitions is applicable.

Under Section 882(b), "[i]n the case of a foreign corporation, *except where the context clearly indicates otherwise*, (italics added) gross income includes only (1) gross income from U.S. sources that is not effectively connected with a U.S. trade or business, and (2) gross income that is effectively connected with the conduct of a U.S. trade or business." Thus for each foreign corporation it is necessary to consider whether the general rule of Section 882(b) is applicable or, alternatively, whether the *context* where the term gross income is used clearly indicates that another definition should be used. At a minimum, however, the wording of Section 882(b) makes it clear that the concept of gross income may be expanded or modified for certain foreign persons.

In determining if the present situation is one where the context clearly indicates that gross income should include items from non-U.S. sources and not effectively connected with a U.S. trade or business, the legislative history of Section 1059 provides some guidance. Section 1059 was enacted as part of the Tax Reform Act of 1984. The legislative history is

comprised of H.R. No. 98-861 (1984) ("House Report"); at 800, and General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 ("Blue Book"), at 136. The Blue Book in particular spells out that Section 1059 was enacted specifically to stop a transaction called "dividend stripping." As described in the Blue Book, in a dividend strip, a corporate taxpayer purchases stock prior to the ex-dividend date for an impending dividend, collects the dividend, and sells the stock as soon as it has been held for the period sufficient to earn a "dividends received deduction" ("DRD"). Generally the price of the underlying stock will have declined by the amount of the dividend, so the sale produces a capital loss. Such loss is used to offset other capital gains so that the outcome is a conversion of fully capital gains into ordinary income taxed at a low effective rate due to the availability of the DRD. In the 1984 Act, Congress attacked this transaction in several ways. The DRD holding period was lengthened to 46 days, the DRD holding period was suspended where the taxpayer eliminated his economic risk by certain types of hedging, and Section 1059 eliminated the opportunity for a capital loss immediately following the receipt of the dividend.

Based on the 1984 Blue Book and Committee Report, it is clear that Section 1059 was enacted solely to stop dividend stripping by domestic corporations who could take advantage of the DRD, and there is nothing in the legislative history to indicate that it was ever intended to reach situations other than domestic dividend payments that qualify for the DRD. Therefore Section 1059's context, including legislative history, strongly suggest that foreign corporations which could not qualify for a DRD were never intended to be caught by Section 1059. Thus, to exclude dividends received by Investco from "gross income" would cause a result unrelated to the purpose behind the enactment of Section 1059. This is also significant evidence that in the context of Section 1059, the use of the term "gross income", as applied to foreign corporations, should not be defined as a tax trap for those foreign corporations.

Further evidence that Congress could not have intended to apply Section 1059 to foreign corporations receiving a foreign source dividend is provided by some of the absurd results that would follow. For example, if a "controlled foreign corporation" ("CFC") received a dividend from another foreign corporation that was Subpart F income to its U.S. shareholder, Section 1059 would appear to subject the U.S. shareholder to double taxation by reducing the CFC's tax basis in the dividend paying shares. Other examples can be found in the foreign tax credit area and the foreign personal holding company ("FPHC") rules.

An alternative approach to the context question is to look at the way the term gross income is used in the CFC, passive foreign investment company ("PFIC"), and FPHC rules. Since *Investco* satisfies each of these definitions (as discussed below), these rules should provide support for using their definitions of gross income rather than the one found in Section 882(b). As described below, the context of each of these Sections clearly supports defining gross income differently than Section 882(b).

Controlled foreign corporations are not directly subject to U.S. tax. Rather, Section 951 generally states that certain "U.S. shareholders" of a CFC are subject to U.S. tax through a deemed dividend mechanism on their ratable share of CFC's "Subpart F" income. Nevertheless, a determination of the CFC's gross income is required in determining the CFC's Subpart F income. For example, Section 954(c)(1) says, "for purposes of subsection (a)(1), the term 'foreign personal holding company income' means the portion of the *gross income* which consists of: dividends etc..." (italics added). Thus, it would appear that the CFC rules are a place "where the context clearly indicates" that gross income should include categories of income such as foreign source dividends.

PFIC's are defined as such if they satisfy either a passive gross income test or passive assets test. Like CFC's, they are not directly subject to U.S. tax. PFIC shareholders are subject to U.S. tax and an interest charge on their share of PFIC distributions or deemed distributions. Also like CFC's, a determination of the PFIC's gross income is required for several purposes. First, Section 1296(a)(1) states "the term 'passive foreign investment company' means any foreign corporation if 75 percent or more of the *gross income* of such corporation for the taxable year is passive income..." (italics added). In addition, Section 1296(b)(1) also provides that the term "passive income" is defined by reference to the definition of foreign personal holding company income quoted immediately above. The language used in the PFIC rules indicates that PFIC's are another instance where a broader definition of gross income, that includes foreign source dividends, is appropriate.

The foreign personal holding company rules are a third case where an expansive definition of gross income is required. For example, an FPHC is defined at Section 552(a) as such by reference to a 60 percent *gross income* test. Furthermore, for purposes of the FPHC rules, "gross income" is defined by Section 555(a) as follows:

"For purposes of this part, the term 'gross income' means, with respect to a foreign corporation, gross income is computed...as if the foreign corporation were a domestic corporation which is a personal holding company."

The personal holding company rules in turn refer to "gross income" at Section 543(b)(1) and Regulation Section 1.542-2. Regulation Section 1.542-2 says: "For the definition of 'gross income' see Section 61 and Section 1.61-1 through 1.61-14". Thus by specific reference the FPHC rules incorporate Section 61's broad definition of gross income to test an FPHC's status as an FPHC and to measure its FPHC income. This is perhaps the clearest case where the more restrictive Section 882(b) definition should not be applicable because the context, and specific wording of the Sections, indicate otherwise.

While it is not completely clear that a FPHC (for example) that receives an extraordinary dividend should define gross income in a Section 1059 calculation by reference to the FPHC definition of the term, such a result is supported by definitions found in the FPHC Sections. Furthermore, the alternative would be to use the Section 882(b) definition and produce a result that Congress never intended. On balance, the better view is that Section 1059 does not apply to a foreign corporation not otherwise directly subject to U.S. income tax and, that if one were to attempt to apply Code Section 1059 to such a corporation, the CFC/FFIC/FPHC rules clearly indicate that the term gross income must be read to include foreign source dividends received by a foreign corporation for purposes of determining the taxable portion of such a dividend under Code Section 1059. Based on the foregoing, it is more likely than not that Code Section 1059 will not cause a reduction on the basis of the Foreign Bank stock.

7. Applicability of Section 1091 Wash Sale Rules. Section 1091 precludes taxpayers from claiming losses from the sale of stock or securities if they acquire the same or substantially identical stock or securities during the period beginning 30 days before, and ending 30 days after, the date on which the loss transaction occurred. In the proposed transaction, it is possible that the basis accession by U.S. Entity may cause it to realize a loss upon its ultimate disposition of Foreign Bank stock. In the event that Invesco's acquisition of Foreign Bank were attributed to U.S. Entity and such acquisition occurred within 30 days of U.S. Entity's ultimate disposition of Foreign Bank stock, this provision could apply to deny U.S. Entity any losses upon such disposition.

There is no authority, however, for applying the "wash sale" rules in the instant case. First, there is no provision for the aggregation of sales and purchases by related parties under those rules. Second, the ownership attribution rules of Section 318 do not apply to Section 1091. Finally, U.S. Entity does not intend to sell its Foreign Bank stock and options within 30 days of the date that Investco will purchase or redeem its Foreign Bank stock. As such, it is more likely than not that any losses realized by U.S. Entity would not be limited by Section 1091.

8. Effect of Proposed Legislation (H.R. 1551 and S. 750). Certain legislation was proposed in the U.S. Congress on May 3, 1995 which might affect these transactions. If enacted, this legislation would amend Section 302(b) to provide that, except as provided in regulations, a redemption of stock by a corporate shareholder after May 3, 1995, would be treated as a sale or exchange under Section 302(a) (and not as a distribution) if (1) the redemption was either in partial liquidation or not pro rata as to all shareholders and (2) but for the new provision, the corporate shareholder would have been eligible for a dividends received deduction, described above, with respect to such redemption. Such corporate shareholders would also be barred from recognizing loss solely by reason of application of the new provision. This provision also does not appear applicable to U.S. Entity, Foreign Bank, and Investco because the redemption of Investco's Foreign Bank stock will not qualify for the dividends received deduction for the reasons described above. A similar proposal is contained in the Administration's 1998 Budget Proposal.

9. Provisions Concerning Controlled Foreign Corporations. Sections 951-964, collectively referred to as Subpart F, provide special rules to prevent U.S. persons from deferring the recognition of certain foreign income from U.S. Federal income taxation. This is achieved by providing that the "Subpart F income" earned by a CFC is deemed distributed as a dividend to its U.S. shareholders on an annual basis. As such, if Investco were a CFC and U.S. Entity was treated as a U.S. shareholder for purposes of allocating income from Investco, the dividend income of Investco would be included in U.S. Entity's income.

Under Section 957(a), a CFC is any foreign corporation if (1) more than 50% of the total combined voting power or (2) more than 50% of the total value of the stock of such corporation is owned by one or more U.S. shareholders. Section 957(a) defines a U.S. shareholder as any U.S. person that owns 10% or more of the total combined voting power of a foreign corporation. Section 958(b) provides that the determination of who is a U.S.

shareholder and whether or not a foreign corporation is a CFC is made with the application of the constructive ownership rules of Section 318(a) (including the option exercise rule of Section 318(a)(4)).

U.S. Entity's constructive ownership of 80% of Investco gives it indirect control over Investco. Therefore, because the definition of CFC status includes U.S. shareholders who indirectly own greater than 50% of a foreign corporation's stock, the Warrant will cause Investco to be a CFC. See Section 958(b). However, despite U.S. Entity's characterization as a U.S. shareholder, it does not directly own any Investco stock and should not be required to include any of Investco's Subpart F income. Regulation Section 1.951-1(a)(2) provides that only those U.S. shareholders who "own (within the meaning of Section 958(a)) stock in such corporation on the last day" of the taxable year of the CFC must include in income that CFC's subpart F income. Section 958(a) provides that "stock owned" means only stock owned directly and through foreign entities. Because Section 958(a) does not include stock constructively owned by application of Section 318, it is more likely than not that U.S. Entity would not have to include in its income any portion of Subpart F income that Investco might happen to earn.

Notwithstanding this general rule, the IRS ruled in Rev. Rul. 82-150, 1982-2 C.B. 110, that under the circumstances described in the Ruling, the holder of a call option on shares of a foreign corporation would be treated as actually owning the shares for purposes of the Subpart F rules. In the Ruling, a nonresident alien individual formed a foreign corporation, contributing \$100,000 for all of its issued and outstanding stock. A U.S. person then paid the nonresident alien \$70,000 for an option to acquire all of the foreign corporation's stock from the nonresident alien individual for \$30,000 at any time. The Ruling's rationale was that the high premium paid for the option (\$70,000), combined with the fact that the option was deep in the money (\$30,000) caused the U.S. person to bear the burdens and gain the benefits of ownership of the stock. Stated differently, the high premium and the deep in the money position provided a very high degree of likelihood that the option would be exercised. See, e.g., Rev. Rul. 83-98, 1983-2 C.B. 40, in which a convertible note was treated as equity because of the high probability that the note, worth \$600 at maturity, would be converted into stock currently worth \$1,000.

In the instant case, and unlike the facts presented in Rev. Rul. 82-150, *supra*, the Warrant is not unlimited, but rather has a 1 year term. Furthermore, in the instant case, the

exercise of the Warrant by U.S. Entity is not solely dependent upon the value of the Investco stock, but rather depends on the overall trading strategy of U.S. Entity with respect to the Foreign Bank stock. Based on the foregoing, although the matter cannot be entirely free from doubt because of the factual nature of the issue, it is our opinion that it is more likely than not that U.S. Entity will not be treated as the actual owner of the Investco stock for purposes of the Subpart F rules.

10. Provisions Concerning Passive Foreign Investment Companies. A U.S. person that owns stock in a passive foreign investment company ("PFIC") generally is subject to additional taxes on "excess distributions" from a PFIC and any gains upon the sale of stock in a PFIC. However, if the U.S. shareholder elects to treat the PFIC as a "qualified electing fund" ("QEF") it will not be subject to the additional taxes above, but will instead be required to include currently in gross income its respective share of the PFIC's total earnings. The U.S. shareholder can elect to defer payment of taxes attributable to income from QEF not currently received, but will be subject to an interest charge.

If Investco is a PFIC and U.S. Entity is deemed to be a U.S. shareholder of Investco, U.S. Entity would be required either to elect to be treated as a qualified electing fund and include a share of this dividend in its income for U.S. Federal income tax purposes, or not elect to be treated as a qualifying electing fund and pay a deferred tax amount when such dividend is distributed.

Section 1296 generally provides that a foreign corporation is a PFIC if: (i) 75 percent of more of its gross income for the taxable year consists of passive income, or (ii) 50 percent or more of the average fair market value of its assets consists of assets that produce, or are held for the production of passive income. The dividend income that Investco will be deemed to earn from the redemption of its Foreign Bank stock will constitute passive investment income under Section 1296(b). Investco's only direct shareholder is Foreign Person, however, the Warrant is deemed exercised under Section 1297(a)(4), and therefore, U.S. Entity is considered to own 80% of Investco's stock.

U.S. Entity's constructive ownership of 80% of Investco gives it indirect control over Investco. Therefore, because the definition of a PFIC includes U.S. shareholders who indirectly own greater than 50% of a foreign corporation's stock, the Investco warrant will cause Investco to be a PFIC. However, because U.S. Entity will not have a direct ownership

of Investco shares within the meaning of Section 1293(b) (in the case of a qualified electing fund) and will not hold stock for purposes of Section 1291(a)(1)(A) (in the case of a nonqualifying fund), it is more likely than not that it should not result in U.S. Entity's either including in income of paying a deferred amount on any passive investment income earned by Investco.⁷

11. Source of Capital Loss From U.S. Entity's Disposition of Foreign Bank Shares. Although it is not certain whether U.S. Entity will recognize capital gain or loss upon its ultimate disposition of Foreign Bank stock, the source of this gain or loss (i.e., whether it is sourced within or without the United States) could have important tax consequences for U.S. Entity. Generally the source of U.S. Entity's capital gain or loss on the disposition of its Foreign Bank shares should be categorized as a U.S. source under Section 865(a)(1) and Section 865(j)(1).

On July 8, 1996, the Secretary issued Proposed Regulation Section 1.865-2(a) which provides a general rule that stock losses are allocated in the same manner as gains, i.e., based on the residence of the seller. The above regulations are proposed to be effective for taxable years beginning after sixty days after the date final regulations are published in the Federal Register. However, a taxpayer may elect to apply the regulations retroactively to stock losses in all open post-1986 years, by filing an election with an original or amended return.

An exception to the above general sourcing rule is found in Proposed Regulation Section 1.865-2(b)(1). This exception provides that to the extent of the "dividend recapture amount" a loss shall be allocated to the same class of income as any dividend received in the prior twenty-four months. A dividend recapture amount includes an actual dividend, a subpart F or qualified electing fund inclusion attributable to a dividend received by a controlled foreign corporation in a separate limitation category other than passive income, and an inclusion attributable to Section 956 or 956A.

The Proposed Regulations also address the treatment of losses allocated to the separate category of passive income for purposes of the limitation on the foreign tax credit under Section 904(f). Generally, the proposed amendments provide that if after allocation and

⁷ See the discussion of Rev. Rul. 82-150, 1982-1 C.B. 110 at Section III C.9. of this Memorandum.

apportionment of all deductions, net income in a category is less than zero, any taxes imposed with respect to the group are considered related to general limitation income. The net loss is not considered related to general limitation income, but proportionately reduces income in the other passive income groups. Any net loss in the Section 904(d) separate category for passive income constitutes a separate limitation loss governed by Section 904(f)(5).

It is not anticipated that U.S. Entity will receive a dividend recapture amount described above from its holding of Foreign Bank stock. Nor is it anticipated that if U.S. Entity does receive a dividend recapture amount that such amount will cause an overall loss in any separate category of income. However, if this is not the case, and U.S. Entity realizes a loss on the disposition of Foreign Bank stock, such dividend recapture amount will be recategorized as foreign source loss to such extent and under the rules described above.

D. Applicability of Section 6662(b)(2).

Section 6662 imposes a penalty if there is a substantial understatement of income tax for a taxable year. Section 6662(d)(2) provides certain mitigation provisions. Such mitigation provisions generally do not apply if the item to which the understatement relates is attributable to a tax shelter, and Section 6662(d)(2)(C)(ii) specifically provides such mitigation provisions are not available to a corporation if the understatement is attributable to a tax shelter. We have assumed solely for purposes of the analysis of these penalty provisions that the transactions described herein constitute a tax shelter and that the more stringent rules applicable to corporations could be applied to U.S. Entity. Because the rules applicable to corporations involved in tax shelters encompass the same and greater requirements than those applicable to individuals and non-tax shelters, satisfaction of such rules applicable to will ensure that U.S. Entity will not be subject to penalties under Section 6662.

Notwithstanding the general rule imposing a penalty for substantial understatements, Section 6664(c)(1) provides that no such penalty will be imposed if it can be shown that there was reasonable cause for the understatement and the taxpayer acted in good faith with respect to such portion. Regulation Section 1.6664-1(e) provides rules for determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter.

Regulation Section 1.6664-1(e)(1) provides that the question of whether a corporation has acted with reasonable cause and in good faith with respect to a tax shelter is based on all pertinent facts and circumstances. Treasury Regulation Section 1.6664-1(e)(2) permits a corporation's legal justification to be taken into account in establishing reasonable cause and good faith if (i) it meets the authority requirement of Treasury Regulation Section 1.6664-4(e)(2)(A) which requires that there be substantial authority for the tax treatment of the item within the meaning of Treasury Regulation Section 1.6662-4(d) and (ii) it meets the belief requirement of Treasury Regulation Section 1.6664-4(e)(2)(B)(ii) which requires that the corporation reasonably relies in good faith on the opinion of a professional tax advisor that there is greater than a 50% likelihood that the tax treatment will be upheld if challenged by the IRS. Treasury Regulation Section 1.6662-4(d)(2) provides that the substantial authority standard is less stringent than "more likely than not" (i.e., greater than a 50% chance of the position being upheld) but more stringent than a "reasonable basis" standard. Thus in meeting the Regulation Section 1.6664-4(e)(2)(A) authority requirement and Regulation Section 1.6664-4(e)(2)(B)(ii) belief requirement there must be a greater than 50% likelihood that the taxpayer would prevail were the IRS to challenge the position.

Based on the foregoing, U.S. Entity should not be subject to penalties under Section 6662(d) with respect to the treatment in its U.S. Federal income tax return of the items discussed herein because, as required by Section 6664(d) and the Regulations promulgated thereunder, based on our opinions above and the discussion of such opinions in the text of this letter, as required by Regulation Section 1.6664-4(e)(2)(B)(ii) substantial authority for such treatment should exist and as required by Regulation Section 1.6664-4(e)(2)(B)(ii) it is more likely than not that such treatment will be sustained if challenged by the Internal Revenue Service.

IV. Conclusion

Based on the foregoing and under current U.S. Federal income tax principles, we conclude that it is more likely than not that, upon the complete redemption of Investco's Foreign Bank shares as contemplated herein, the proper tax treatment of the basis of such shares is to add it to the basis of U.S. Entity's Foreign Bank shares and possibly its options. Based on such conclusion, we also believe that it is more likely than not such basis adjustment will result in U.S. Entity recognizing greater loss (or lesser gain) upon its

ultimate disposition of its Foreign Bank shares and options than it otherwise would have recognized.

In rendering the foregoing opinions, we express no opinion as to the laws of any jurisdiction other than the Federal income tax laws of the United States. We are relying upon the relevant provisions of the Code, the regulations thereunder, and the judicial and administrative interpretations thereof, as of the date hereof. Such authorities are subject to change or to modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless you specifically request otherwise, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof. Furthermore, our conclusions are based on the completeness and accuracy of the above-stated facts and assumptions. In the event any of the foregoing facts and assumptions change or are found inaccurate, it is imperative that we be informed immediately, as such change or inaccuracy could have a material effect on our conclusions.

This opinion is furnished to you solely for your benefit in connection with your participation in the proposed transaction and is not to be used, circulated, quoted or otherwise referred to for any other purpose without our express written permission.

Very truly yours,

[Brown & Wood LLP]

3754

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=22637
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=22637
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: B&W Draft Opinion
Sent: 1999-10-29 19:10:11.233
Date: 1999-10-29 19:10:11.806
X-Folder: Sales Assistance

One other question. What is best way for my blips clients to monitor their investment during stage 1? I'm not aware of them receiving anything since they completed paperwork.

-----Original Message-----

From: Liston, Shannon L
Sent: Friday, October 29, 1999 2:08 PM
To: Eischeid, Jeffrey A
Subject: FW: B&W Draft Opinion

Jeff, I'm in town for a couple of weeks and ready to get going on this. The message I received didn't have RJ's attachment. Is Randy the best person for me to work with re: latest version of our opinion and B&W opinion, as well as decisions on opinions for pre-/post-10/18 transactions, aggregation opinions, and Gibson Dunn opinions? Any other variations?

-----Original Message-----

From: Liston, Shannon L
Sent: Monday, September 27, 1999 12:34 PM
To: Eischeid, Jeffrey A
Cc: Carbo, Deke G; Ito, Dennis A
Subject: RE: B&W Draft Opinion

Of course, thanks. Help me with timing. My priorities right now are closing my blips transactions (1 in process, 2 on waitlist), helping process other blips, Midco approval and rollout. I'm arriving in NY today and will be available by email, and checking vmail.

-----Original Message-----

From: Eischeid, Jeffrey A
Sent: Monday, September 27, 1999 11:33 AM
To: Liston, Shannon L
Cc: Carbo, Deke G; Ito, Dennis A
Subject: FW: B&W Draft Opinion

Are you up for this?

-----Original Message-----

From: Watson, Mark T
Sent: Monday, September 27, 1999 10:17 AM
To: Eischeid, Jeffrey A; 'R. J. Ruble'; Bickham, Randall S
Subject: RE: B&W Draft Opinion

Using Shannon to review the opinions is fine with me.

-----Original Message-----

From: Eischeid, Jeffrey A
Sent: Saturday, September 25, 1999 9:37 AM
To: 'R. J. Ruble'; Bickham, Randall S; Watson, Mark T

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 302

KPMG 0033496

3755

Subject: RE: B&W Draft Opinion

Good ideas. Shannon Liston may be a good choice. Mark & Randy what do you think?

Jeff

-----Original Message-----

From: R. J. Ruble [SMTP:rruble@brownwoodlaw.com]

Sent: Friday, September 24, 1999 7:27 PM

To: eischeid@kpmg.com; rbickham@kpmg.com

Subject: B&W Draft Opinion

Here's our opinion. In going through it I noticed some minor changes that need to be made to both. I have put in an assumption about functional currency, I don't think yours has it and we probably both want it as a rep. There are a number of investor reps in the text that aren't in the Reps section. I think that they should go in there. I also think we should figure out whether we want more in the way of representations from the Investor's single owner. We both need to get our aggregation opinions ready. Lastly, we probably both need a set of fresh eyes to go over the opinions one last time. At this point I'm not sure that I have anyone. Do you and if so could I prevail on him/her to look at mine as well? A side-by-side is also a good idea to make sure we each cover everything the other has.

----- Forwarded by R. J. Ruble/NY/BWLLP on 09/24/99 07:20 PM -----

R. J. Ruble
09/24/99 07:20 PM

To: drivkin@kpmg.com

cc:

Subject: B&W Draft Opinion

Attached is a draft of our BLIPS opinion as you requested. I apologize about the delay. It will probably go through another round of clean up, but it is substantially completed.
(See attached file: B&W Draft BLIPS opinion letter.doc)

(UUEncoded file named: B&W Draft BLIPS opinion letter.doc follows)
(Its format is: Lotus.Manuscript 1.0)

<< File: B&W Draft BLIPS opinion letter.doc >>

Proprietary Material
Confidentiality Requested

KPMG 0033497

3756



Robert B. Coplan
02/11/2000 10:23 AM

To: William P. Murphy/NOhioEMichigan/TAX/EYLLP/US@EY-NAmerica
cc: Brian L. Vaughn/National/TAX/EYLLP/US@EY-NAmerica, Richard J. Shapiro/NewYork/TAX/EYLLP/US@EY-NAmerica, Martin Nissenbaum/NewYork/TAX/EYLLP/US
Subject: Re: [REDACTED]

I think I can speak for Brian in agreeing that this is very disappointing, but not unexpected. It is clear that the market is still heavily into permanent loss strategies, but it is just as clear that the powers that be in our firm are concerned about the exposure down the road.

William P. Murphy

William P. Murphy 02/11/2000 10:05 AM

Tax / Personal Financial Consulting
Phone Number: (216) 583-2869
Fax Number: (216) 583-2576, eFax (208) 246-6967
Cell Phone: (440) 666-1602 EYComm: 2596877

To: Robert B. Coplan/National/TAX/EYLLP/US@EY-NAmerica, Brian L. Vaughn/National/TAX/EYLLP/US
cc:
Subject: [REDACTED]

I think I speak for several people when I say how dissappointed I am at this development. Please give me your thoughts.

Bill

Forwarded by William P. Murphy/NOhioEMichigan/TAX/EYLLP/US on 02/11/2000 10:03 AM



Alexander L. Eckman
02/11/2000 09:57 AM

To: David G. Johnson/NOhioEMichigan/TAX/EYLLP/US@EY-NAmerica, William P. Murphy/NOhioEMichigan/TAX/EYLLP/US@EY-NAmerica, Stephen W. Kiemash/WesternPA/AUDIT/EYLLP/US@EY-NAmerica, Richard J. Shapiro/NewYork/TAX/EYLLP/US@EY-NAmerica

cc:

Subject: [REDACTED]

I want to summarize my call with [REDACTED] of this morning. [REDACTED] told me the transaction with [REDACTED] is at least 2 weeks away and they are not going to do anything until then. I told him that at this point CDS is the transaction we could offer to them. His reaction was that [REDACTED] wants and will do a permanent loss transaction. CDS is not aggressive enough compared to other deals in the marketplace.

[REDACTED] told me that during the January meeting, Richard Shapiro gave him the name of R.J. Rubell at Brown and Wood and said that they could contact him directly regarding the tax opinion and other issues. He did that. Rubell said that Brown and Wood stands by the deal and is willing to issue the same opinion letter as before. They and others do not see the risk that E&Y sees. Apparently, B&W is also working with Diversified and KPMG and Rubell steered them in that direction. [REDACTED] is inclined to use Diversified for a COBRA like deal. He did say that he will use us, if we can offer a similar permanent loss product. Team-please give me your thoughts and advice.

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 306

2003EY011640

3757

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON
ATTORNEYS AT LAW

55 EAST MONROE STREET - SUITE 4200
CHICAGO, IL 60603-5803
TEL 312 546-8000
FAX 312 558-5844

815 CONNECTICUT AVENUE, N.W. - SUITE 500
WASHINGTON, D.C. 20006-4004
TEL 202 463-5400
FAX 202 528-5263

1270 AVENUE OF THE AMERICAS - SUITE 1500
NEW YORK, NY 10020-1801
TEL 212 512-5500
FAX 212 512-5525

101 CALIFORNIA STREET - SUITE 2900
SAN FRANCISCO, CA 94111-0864
TEL 415 397-8253
FAX 415 397-8549

ONE CENTURY PLAZA - SUITE 3300
2029 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067-3063
TEL 310 277-7200
FAX 310 201-5219

WRITERS DIRECT DIAL

(310) 201-5222

whitemi@la.seyfarth.com

400 CAPITOL MALL - SUITE 1250
SACRAMENTO, CA 95814-4400
TEL 916 557-5158
FAX 916 558-4529

700 LOUISIANA STREET - SUITE 3850
HOUSTON, TX 77002-2731
TEL 713 255-2200
FAX 713 255-2348

ONE ATLANTIC CENTER - SUITE 5050
1261 WEST PEACHTREE STREET
ATLANTA, GA 30309-3400
TEL 404 893-5412
FAX 404 893-7056

INTERNATIONAL
AVENUE LOUISE 500, BOITE 9
1050 BRUSSELS, BELGIUM
TELEPHONE 02 2 847 5035
FAX 02 2 847 5071

December 30, 1999

23629-1



VIA FACSIMILE AND U.S. FIRST CLASS MAIL

Mr. Tom Lopez
L.A. Fire & Police Pension System
360 East Second Street, Suite 600
Los Angeles, California 90012

Re: Contribution Donation: L.A. Fire & Police Pension System

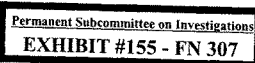
Dear Tom

You have asked us to advise you concerning the ability of the L.A. Fire & Police Pension System (the "Plan") to accept a contribution from an unrelated third party in the form of nonvoting stock of a closely-held California S corporation. Below is set out a brief summary of our conclusions on this issue, a summary of the facts which have been provided to us, and an analysis of the relevant authority and issues.

Summary

Although this is a very unusual transaction, and there is almost no statutory, regulatory or other authority addressing the issue, we believe the Plan is permitted to accept a contribution to the Plan from an unrelated third party in the form of nonvoting common stock of an S corporation, and

LA1 6245417 v 3



SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
December 30, 1999
Page 2

that the risks of doing so are very small. There is at least one (very old) ruling from the Internal Revenue Service ("IRS") involving similar facts, which does not identify any problems for the recipient plan. In addition, we found no state or local law, rule or regulation which prohibits the acceptance of this type of property "donation." The City Charter does contain, however, a prohibition against "investing" in more than five percent (5%) of the common stock of a single company, but we believe there are very good arguments that this prohibition does not apply here -- most notably, because the Plan is not actually using its own money to "invest" in the stock, but is receiving the stock as a donation. Finally, there appears to be little doubt that the receipt of the stock is in the best interests of Plan participants, since it has the potential to benefit the Plan without any material corresponding cost.

It should be noted that, from a procedural and due-diligence standpoint, (1) we have not been asked to conduct, and we have not conducted, any investigation into the company and/or the individual involved, (2) we have not yet reviewed any of the underlying documentation in connection with the donation or the possible future redemption of the stock, and offer no opinion on such agreements or their impact on any of the views expressed in this letter, (3) we have not examined, or opined in any way about, the impact of the transaction on the "donor" from a tax or other standpoint, and (4) we have not checked the investment against any investment policy guidelines that may have been adopted by the Board.

Facts

The Plan is, and always has been, intended to be a tax-qualified retirement plan within the meaning of § 401(a) of the Internal Revenue Code of 1986, as amended (the "Code"). The Plan is a "governmental plan" within the meaning of Code § 414(d) because it has been established and is maintained by a political subdivision, agency or instrumentality of the state of California. Individual A (the "Primary Shareholder") is the sole owner of 100% of the issued and outstanding stock in corporation X, an S corporation within the meaning of Code § 1361(b) formed under California law. Corporation X has only one class of stock. The Primary Shareholder desires to make a contribution or donation to the Plan in the form of a portion of the nonvoting common stock of corporation X. The number of shares will be more than 50% of the total nonvoting shares of the common stock of corporation X, which will constitute less than 25%, but more than 5%, of the total value of corporation X. Neither the Primary Shareholder nor corporation X is related, either personally or through any business contract, to the Plan, to any member of the pension board, to the City of Los Angeles, or to any elected official of the City of Los Angeles. Corporation X intends to take a deduction for the contribution it makes to the Plan in the tax year in which it is made. Corporation X is in the business of selling products.

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
 December 30, 1999
 Page 3

The Plan will be required to execute a redemption agreement which will provide, in effect, that the Plan will have the right to "put" the stock back to the corporation (or one of its shareholders) at some point in the future (which we are advised will be in approximately two years). The purchase of the stock by the corporation (or one of its shareholders) will occur at the then fair market value, but in no event at a value less than the fair market value of the stock as of the date the contribution of the stock is made to the Plan. We are advised that the Plan will not be permitted to sell or otherwise transfer the stock prior to the redemption.

We have been advised, and we assume as correct, that neither the Plan, nor any Commissioner, is giving to Corporation X, the Primary Shareholder, or any other person or entity, any consideration of any kind, direct or indirect, in connection with this transaction.

All the facts set out in this letter, except that regarding the existing tax-qualified status of the Plan and the status of the Plan as a governmental plan, have been provided to us by Larry Manth of KPMG Peat Marwick, in Los Angeles. If any of the facts or deal points are different from those provided, the views expressed in this letter could change, and this letter could not be relied upon. Therefore, please notify us immediately if any stated fact is incorrect or is changed.

Continued Qualification under Code § 401(a)

Section 401(a)(1) of the Internal Revenue Code of 1986, as amended (the "Code") provides as follows:

(a) REQUIREMENTS FOR QUALIFICATION. — A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section —

(1) if contributions are made to the trust by such employer, or employees, or both, or by another employer who is entitled to deduct his contributions under section 404(a)(3)(B) (relating to deduction for contributions to profit-sharing and stock bonus plans), or by a charitable remainder trust pursuant to a qualified gratuitous transfer (as defined in section 664(g)(1)), for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan[.]

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
December 30, 1999
Page 4

Thus, Code § 401(a)(1) contemplates that contributions to retirement plans qualified under § 401(a) will be made by employers (or their related employers) and employees, and not by third parties.

The IRS has ruled, however, that Code § 401(a)(1) "does not require . . . that contributions be made *only* by the employer or by the employees." Rev. Rul. 63-46, 1963-1 C.B. 85. *See also* Rev. Rul. 69-35, 1969-1 C.B. 117 ["Thus, the immediate source of the contributions [parent corporation for subsidiary's employees, and *vice versa*] to the pension trust will not adversely affect the qualified status of the plan and trust, even though such contribution was made by third parties," citing Rev. Rul. 63-46; Rev. Rul. 68-223, 1968-1 C.B. 154 ["Thus, the immediate source of the contributions [transferred to a pension trust from a welfare fund] to the pension trust will not adversely affect the qualified status of the plan and trust, since such contribution may even be made by third parties."]]

Two other items should be noted. First, a nearly identical fact situation was considered by the IRS in Revenue Ruling 58-154, 1958-1 C.B. 125. This ruling also involved a pension plan for the benefit of municipal employees. According to the facts set out in the ruling, that plan specifically provided that, from time to time, the pension board could accept contributions donated by unrelated third parties. On these facts, the IRS held that contributions donated to the plan by a third party were deductible to the third party under Code section 170. In rendering its opinion on this point, it is significant to note that the IRS does not mention any adverse effect on the qualification of the plan under § 401(a) on account of its acceptance of a contribution from a third party. While the IRS' silence is certainly not tantamount to its actually having ruled on this point, we nonetheless believe that the IRS, in issuing a ruling which concerns a qualified plan, would likely have raised the issue if it believed that the acceptance of the third-party contribution would subject the plan to disqualification under the Code, because tax-qualification is the cornerstone of any qualified retirement plan.

Second, given the absence of any directly applicable authority on this issue, we contacted, on a no-names basis, a couple of representatives at the Service to discuss the issue. For example, we had a telephone discussion with James Holland, Chief, Actuarial Branch, of the IRS National Office. We explained the facts, as set out in this letter, to Mr. Holland, and discussed the potential effect, if any, on the tax-qualification of the Plan under Code § 401(a) if it were to accept a contribution from an unrelated third party. Mr. Holland indicated that this unusual situation did not seem to violate any provision of the Code or otherwise threaten the tax-exempt status of the Plan. Mr. Holland indicated that he was basing his response on the fact that Code § 401(a) does not set out a specific *requirement* that contributions be made solely by the employer sponsoring the qualified plan, but is rather a more oblique reference to the fact that contributions will be made to the plan by the employer sponsoring the plan. These types of informal conversations are not binding on the

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
 December 30, 1999
 Page 5

Service, but they do provide a good, informal indication as to how this transaction would likely be viewed by the IRS. Moreover, in this instance, Mr. Holland's response is in line with the revenue rulings from the 1960s cited earlier (e.g., Rev. Rul. 63-46), although he did not specifically mention these or any other rulings during the course of our conversation.

Accordingly, we have concluded that a contribution made by Corporation X to the Plan should not alone cause the Plan to lose its tax-qualified status within the meaning of Code § 401(a).

Plan As Shareholder in An S Corporation

Section 1361(c)(6) of the Internal Revenue Code of 1986, as amended (the "Code") provides as follows:

(6) CERTAIN EXEMPT ORGANIZATIONS PERMITTED AS SHAREHOLDERS. – For purposes of subsection (b)(1)(B)¹, an organization which is –

- (A) described in section 401(a) or 501(c)(3), and
- (B) exempt from taxation under section 501(a),

may be a shareholder in an S corporation.

Accordingly, we have concluded that the Plan is a permissible shareholder of an S corporation.

Code § 1361(b)(1)(A) requires that, in order to be eligible for status as an S corporation, a corporation cannot have more than 75 shareholders. In Private Letter Ruling 1999906044, the IRS ruled that an employee stock ownership plan [a type of tax-qualified plan within the meaning of Code § 401(a)] which held all the stock of an S corporation was the sole shareholder (and that the plan's participants were not counted as separate shareholders of the S corporation). The ruling based this conclusion on the legislative history of § 1316 of SBJPA, which provides that "[f]or purposes

¹Subsection 1361(b) lists the requirements a corporation must meet in order to be an S corporation; § 1361(b)(1)(B) sets forth the requirement that the entity not "have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual[.]" Subsection 1361(c)(6) was added as a new provision to the Code, effective for tax years beginning on and after January 1, 1998, by § 1316(a)(2) of the Small Business Job Protection Act of 1996 ("SBJPA").

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
 December 30, 1999
 Page 6

of determining the number of shareholders of an S corporation, a qualified tax-exempt shareholder will count as one shareholder." S.Rep.No. 281, 10th Cong., 2d Sess. 231 (1996). While private letter rulings technically apply only to the taxpayer who applies for the ruling, the legislative history of the pertinent provision in the Code, § 1361(c)(6), clearly indicates that Congress intended a tax-qualified plan under Code § 401(a) to constitute only one shareholder (and that the participants in the plan are not themselves separate shareholders).

Accordingly, we have concluded that the Plan may be a shareholder in an S corporation, and that the Plan would be treated as a single shareholder.

Plan Assets

Because the S corporation involved is not publicly traded, an issue arises as to whether the underlying assets of the S corporation, if the Plan held the stock of the corporation, would be treated as assets of the Plan.² Department of Labor ("DOL") Regs. § 2510.3-101(a)(2) provides in relevant part as follows:

Generally, when a plan invests in another entity, the plan's assets include its investment, but do not, solely by reason of such investment, include any of the underlying assets of the entity. However, in the case of a plan's investment in an equity interest of an entity that is neither a publicly-offered security nor a security issued by an investment company registered under the Investment Company Act of 1940 its assets include both the equity interest and an undivided interest in each of the underlying assets of the entity unless it is established that –

- (i) The entity is an operating company, or
- (ii) Equity participation in the entity by benefit plan investors is not significant.

²We note that the Plan is not subject to Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), under which the above plan asset regulations are promulgated, and there is very serious doubt as to whether the Plan asset regulations would apply. We nonetheless include this section in the unlikely event that it is determined that these rules somehow apply to governmental plans, now or in the future.

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
 December 30, 1999
 Page 7

Therefore, any person who exercises authority or control respecting the management or disposition of such underlying assets, and any person who provides investment advice with respect to such assets for a fee (direct or indirect), is a fiduciary of the investing plan. [Emphasis added]

The nonvoting stock of corporation X is not a "publicly-offered security" as that term is defined in DOL Regs. § 2510.3-101(b)(2) because, among other reasons, the nonvoting common stock of corporation X is not owned by 100 or more independent investors (*see* DOL Regs. § 2510.3-101(b)(2) and (3)), nor is the stock intended to be donated registered under the Securities Exchange Act of 1934 or being sold to the Plan as part of a public offering (*see* DOL Regs. § 2510.3-101(b)(2)(i) and (ii)). Therefore, in order to answer the question of whether the assets of corporation X would be considered to be "plan assets" under these regulations, we need to know whether corporation X comes within either of the two exceptions to the general rule, as set forth in DOL Regs. § 2510.3-101(a)(i) and (ii) set out above.

Is corporation X an "operating company?" DOL Regs. § 2510.3-101(c) provides as follows:

(c) "Operating Company". (1) An "operating company" is an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital. The term "operating company" includes an entity which is not described in the preceding sentence, but which is a "venture capital operating company" described in paragraph (d) or a "real estate operating company" described in paragraph (e).

Larry Manth has represented that corporation X is a general "operating company" within the meaning of DOL Regs. § 2510.3-101(c), as set out above, because the corporation sells products or services. We do not have the background facts on corporation X, but if Mr. Manth is correct, it appears that corporation X would be an "operating company" for purposes of the plan asset regulations, the underlying assets of corporation X would not be considered to be assets of the Plan, and the majority shareholder of corporation X would not be considered to be a fiduciary of the Plan. And, as noted above in Footnote 2, there is a serious question as to whether the plan asset regulations have any application to a governmental plan such as the Plan.

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
December 30, 1999
Page 8

Municipal Charter Provisions

Contributions by Third Parties. There is no explicit provision in the Charter which prohibits contributions to be made to the Plan by third parties.

On the other hand, neither is there an explicit provision which permits contributions to be made to the Plan by third parties. If such a provision existed, there would remain no doubt that, under the Charter, contributions made to the Plan by third parties do not violate any stated Charter purpose.

In the absence of an explicit provision permitting or prohibiting contributions to the Plan by third parties, we have concluded that it is more likely than not that the Plan is permitted to accept contributions from unrelated third parties. This is particularly true in view of the additions to the California Constitution made by Proposition 162, and the fact that the Commissioners are required to act for the exclusive benefit of Plan participants, and to independently assess and act on matters involving the Plan.

Section 190.07. Section 190.07 provides in relevant part as follows:

Not more than 2% of the assets of the funds shall be invested in the common stock of a single corporation **nor shall the total number of shares of common stock held in any single corporation by the funds exceed 5% of the issued and outstanding shares of common stock of such corporation.** [Emphasis added]

The highlighted provision prohibits the Plan from "holding" more than 5% of the stock of a single corporation. Mr. Manth has represented that, after the contribution of corporation X nonvoting common stock has been made to the Plan, it will hold more than 5% of the issued and outstanding shares of the common stock of corporation X.

We note, however, that the highlighted provision cited above is part of the chapter entitled "Investments." The provisions of Charter § 190.07 set out the applicable fiduciary standards on investments which are authorized, as well as the restrictions on the types of investments which may be made. We further note that, although the cited provision purports to limit the percentage of a corporation's stock which the Plan may "hold," the import of that provision, in light of all the other provisions in § 190.07, appears to apply to investments made by expenditure of existing assets of the Plan.

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

Mr. Tom Lopez
December 30, 1999
Page 9

In the contemplated transaction, on the other hand, the stock of corporation X is being donated to the Plan; no existing plan assets are being expended to acquire the stock of corporation X. Accordingly, while the Plan's holding more than 5% of the stock of corporation X may come within the letter of the highlighted provision of § 190.07, it would appear not to come within the intended purview of § 190.07, because the concerns being addressed in § 190.07 are fiduciary concerns in connection with the use of existing plan assets, whereas the stock of corporation X is in addition to those plan assets.

In addition, although we have not been provided with detailed information regarding the capital structure of corporation X, there may also be an argument that the 5% requirement does not apply to the nonvoting common stock, and that this is, in fact, a second class of stock not subject to the 5% limitation. We cannot opine with certainty on this issue, however, without more information.

In sum, it appears that the Commissioners would have a very strong argument, under the very unusual circumstances presented here, that the contemplated contribution of the stock of corporation X to the Plan, and the holding of that stock by the Plan, does not violate the Charter provision limiting the percentage of stock the Plan may hold in a single corporation.

Conclusion

Based upon the limited available legal authority and with the limitations as cited above, we believe that the Plan is permitted to accept a contribution from an unrelated third party in the form of nonvoting common stock of a closely-held California S corporation, and that the legal risks of doing so are minimal.

As a final matter, I want to point out that we have assumed that this letter will be treated as confidential, attorney-client information, and that its distribution will be restricted accordingly. This letter is intended solely for the use of the L.A. Police and Fire Pension System, and should not be used or relied upon by any other person or entity for any other purpose.

3766

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON


Mr. Tom Lopez
December 30, 1999
Page 10

If you should have any questions or comments regarding the information or analysis in this letter, please call me.

Very truly yours,

SEYFARTH, SHAW, FAIRWEATHER & GERALDSON

By



Mitchel D. Whitehead

MDW/LBW:ms

cc: Donna Jones
Commissioners

Author: Jeffrey Zysik at KPMG_WNT
 Date: 5/11/98 5:57 PM
 Priority: Normal
 TO: Gregg W. Ritchie at KPMG_Warner_Center
 TO: Randall S Bickham at KPMG_Silicon_Valley2
 TO: Mark Watson at KPMG_DALLAS4
 TO: Justin P Ransome at KPMG_DALLAS4
 TO: David G. Smith
 TO: Evelyn Elgin
 TO: Mark A. Springer at KPMG_DALLAS4
 TO: Philip J. Wiesner
 Subject: Registration

----- Message Contents -----

I spoke with Dave Smith concerning registration under 6111(c) earlier today. The following points came up:

- 1) If an idea/product is registered as a tax shelter, it probably kills our ability to sell the product (ie, no one will buy it).
- 2) It is Dave's understanding that recently two KPMG professionals informally contacted the IRS concerning 6111(c) registration. They were informed that the Service presently has an informal policy of ignoring 6111(c) registrations, so don't bother. Dave was not sure who had actually contacted the Service, and Eve is not aware of these contacts. I am trying to find out who made these calls. I have also asked Phil Brand to call and find out if there is much registration activity going on currently. I will let you know what he finds out.

In addition, Dave's belief is that when numerous filings were occurring, the Service wasn't doing anything with the information. This is contrary to my and Eve's belief that the Service was sending preemptory letters warning taxpayers not to claim the promoted benefits.

- 3) As a reason for not registering, we should consider the policy argument that the advice we are giving does not meet the paradigm of 6111(c) registration. The wording of 6111(c) (and the regs. thereunder) don't seem to apply to what we are selling - advice. Instead, the language of the sec. appears aimed at the sale of an investment. As a corollary, if we are selling investments, this raises the issue of whether we must be a registered broker/dealer. This is essentially the argument Randy has been making all along.

It is interesting to note that section 6700 defines an abusive tax shelter as "a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement," while sec. 6111 lacks this "plan or arrangement" language. Temp. Regs. 301.6112-1T defines a "potentially abusive tax shelter" as, inter alia, any tax shelter required to be registered. I am not convinced that the 6112-1T definition applies in the sec. 6700 context, however. Perhaps there is an argument based upon the fact that sec. 6700 appears to use a more expansive definition of tax shelter, while sec. 6111 sticks to the term "investment" - something that we are not selling.

- 4) From a businessman's perspective, since the 6111(c) penalty is the greater of 1 percent of the aggregate amount invested in the tax shelter or \$500 (6707(a)), in many cases paying the penalty still

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 313

KPMG 0034805

leaves us with a substantial fee, so why register? Since the 1 percent is levied upon the aggregate value of investments (including, for example, in the case of OPIS those Presidio calls for which we earn no fee) it may not be advantageous for us to be a promoter unless the deal is registered.

5) If we decide to register, we should reevaluate whether the much of the advice we give on a day to day basis should be registered, thereby flooding the Service with registrations and allowing us to educate clients about the breadth of the existing registration rules.

6) If we decide we will be registering in the future, thought should be given to establishing a separate entity that meets the definition of an organizer for all of our products with registration potential. This entity, rather than KPMG, would then be available through agreement to act as the registering organizer (see 301.6111-1T Q&A 38). If such an entity is established, KPMG can avoid submitting its name as the organizer of a tax shelter on Form(s) 8264 to be filed in the future.

When we are ready to raise this discussion to the next level, I suggest that Dave Smith, Phil Wiesner, and Mark Springer be involved in those conversations. It is my understanding that Dave and Phil were primarily responsible for tax shelter registration issues when 6111(c) was a hot topic in the mid-80s.

After Eve and I have met tomorrow I will forward preliminary issues/answers with respect to registration of OPIS.

KPMG 0034806

3769

Author: Jeffrey Zysik at KPMG_WNT
Date: 5/12/98 5:05 PM
Priority: Normal
TO: Gregg W. Ritchie at KPMG Warner_Center
TO: Randall S Bickham at KPMG Silicon_Valley2
TO: Mark Watson at KPMG_DALLAS4
TO: Justin P Ransome at KPMG_DALLAS4
TO: Evelyn Elgin
CC: Mark A. Springer at KPMG_DALLAS4
Subject: Registration requirements.

----- Message Contents -----

Attached is a short Q/A document with preliminary answers to registration questions raised by Gregg. Also, Eve and I have been discussing a possible argument why KPMG might not be required to register the product, or at least might give us reasonable cause for not registering, based upon Q/A-30 of temp. regs. 301.6111-1T.

However, even if we can construct a reasonable cause argument for why KPMG is not required to register the product, that conclusion would not change the substantive conclusion that the product probably meets the definition of a sec. 6111(c) tax shelter. If we cannot come to a conclusion that the product is not a tax shelter, then even if we can argue KPMG is not required to register the idea, can we in good faith participate in its sale without informing a taxpayer that the product probably should be registered?

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 313

KPMG 0034807

Q-1 What information must be given to the IRS with respect to OPIS?

A-1 Section 6111(a)(2)(C) grants the Secretary power to prescribe what information must be disclosed if an investment must be registered as a tax shelter. Form 8264 and the instructions thereto, together with Temp. Regs. 301.6111-1T set forth the information that must be disclosed as part of the tax shelter registration process. Form 8264 is used to register an investment as a tax shelter. Form 8264 is a one and one-half page form. Review of the temp. regs. and Form 8264 present the following practical issues in determining the proper manner of completing Form 8264 for an OPIS transaction

(a) What should be the "tax shelter name"?

Pursuant to the Form 8264 instructions, the name of the tax shelter entity should be used, provided it has a TIN separate from the "principal organizer." In the case of OPIS, it is not clear that the foreign partnership will have a TIN. If a tax shelter entity does not have a TIN, then the name of the "principal organizer" should be used. KPMG (together with Presidio and perhaps others) meet the definition of an organizer, however, it is not clear that KPMG is a principal organizer (see Q/A-27). If KPMG is a principal organizer, one alternative is to use KPMG's name. Alternatively, Presidio's name could be used.

(b) Which KPMG office should be provided as the tax shelter organizer's name (and for the tax shelter, if it is decided to use KPMG in the case of OPIS), and what phone number should be given?

(c) Part II of Form 8264 asks for the tax shelter's type of business organization. Should the type of business organization be listed as a partnership?

The OPIS strategy is not dependent upon the use of a partnership. However, if we check the "other" box, we are required to describe the "type of organization or structure" that constitute the tax shelter. As a result, answering "other" may require us to disclose more information than we would like.

(d) There are a number of other practical issues raised with respect to how certain Form 8264 questions should be answered for OPIS that are obvious from the face of the form.

Q-2 May OPIS be registered only once, or must each separate arrangement structured for a different taxpayer be separately registered?

A-2 It is possible that each OPIS transaction for a particular, single taxpayer must be separately registered. While temp. regs. sec. 301.6111-1T Q/A-22 requires aggregation of all OPIS transactions in determining if the "substantial investment" requirement for a tax shelter is satisfied (IRC Sec. 6111(c)(1)(B)(iii)), Q/A-48 requires that "a separate Form

KPMG 0034808

8264 must be completed for each investment that differs from the other investments in a substantial investment with respect to any of the following:

- (1) Principal asset,
- (2) Accounting methods,
- (3) Federal or state agencies with which the investment is registered or with which an exemption notice is filed,
- (4) Methods of financing the purchase of an interest in the investment,
- (5) Tax shelter ratio.

Although with respect to items 1 through 4 each OPIS transaction (i.e., each investment) probably will not be viewed to differ from the "other investments in [the] substantial investment" each investment's tax shelter ratio may be deemed to vary. However, since the tax shelter ratio is defined as

with respect to any year, the ratio that the aggregate amount of deductions and 200 percent of the credits that are or *will be* represented as potentially allowable to an investor under subtitle A of the Internal Revenue Code for all periods up to (and including) the close of such year, bears to the investment base for such investor as of the close of such year (301.6111-1T Q/A-5, emphasis added),

provided only an illustrative example is used for all taxpayers showing the same potential ratio to each, then it should be possible to register OPIS only once.

Q-3 How long does the registration process take?

A-3 Provided a properly completed Form 8264 is filed by the first date on which an interest is offered for sale (timely mailing rules apply for this purpose - Q/A-49), then the tax shelter is considered registered and the principal organizer of the shelter will be deemed to have met their filing requirement (Q/As-47).

Q-4 What information must be attached to a client's tax return if the client has invested in a tax shelter?

A-4 A taxpayer must attach a Form 8271 to each of his or her tax returns that claim a deduction, loss, credit, or other tax benefit, or on which any income is reported from an interest in a registration-required tax shelter. The Form 8271 reports the tax shelter name, tax shelter registration number, and tax shelter TIN.

Q-5 What additional tax shelter registration rules impact OPIS, if OPIS must be registered.

A-5 There are a number, which follow:

KPMG 0034809

- (a) The seller of a tax shelter must furnish the taxpayer with the registration number on a written statement. Q/A-2 requires the following:

The person who sells (or otherwise transfers) an interest in a tax shelter must furnish the registration number of the tax shelter to the purchaser (or transferee) on a written statement. The written statement shall show the name, registration number, and taxpayer identification number of the tax shelter, and include a prominent legend in bold and conspicuous type stating that the registration number must be included on any return on which the investor claims any deduction, loss, credit, or other tax benefit, or reports any income, by reason of the tax shelter. The statement must also include a prominent legend in bold and conspicuous type stating that the issuance of the registration number does not indicate that the Internal Revenue Service has reviewed, examined, or approved the investment or the claimed tax benefits. The statement shall be substantially in the form provided below:

You have acquired an interest in [name and address of tax shelter] whose taxpayer identification number is [if any]. The Internal Revenue Service has issued [name of tax shelter] the following tax shelter registration number [Number]

YOU MUST REPORT THIS REGISTRATION NUMBER TO THE INTERNAL REVENUE SERVICE, IF YOU CLAIM ANY DEDUCTION, LOSS, CREDIT, OR OTHER TAX BENEFIT OR REPORT ANY INCOME BY REASON OF YOUR INVESTMENT IN [NAME OF TAX SHELTER].

You must report the registration number (as well as the name, and taxpayer identification number of [name of tax shelter]) on Form 8271.

FORM 8271 MUST BE ATTACHED TO THE RETURN ON WHICH YOU CLAIM THE DEDUCTION, LOSS, CREDIT, OR OTHER TAX BENEFIT OR REPORT ANY INCOME.

ISSUANCE OF A REGISTRATION NUMBER DOES NOT INDICATE THAT THIS INVESTMENT OR THE CLAIMED TAX BENEFITS HAVE BEEN REVIEWED, EXAMINED, OR APPROVED BY THE INTERNAL REVENUE SERVICE.

This statement may be modified as necessary if the tax shelter is not a separate entity (e.g., certain Schedule F or Schedule C activities) or has no name or taxpayer identification number.

If the tax registration number has not been received by the time the first interest is "sold," then the second sentence of first paragraph of the above statement must be replaced with the following:

KPMG 0034810

On behalf of [name of tax shelter], [name of tax shelter organizer who has applied for registration] has applied to the Internal Revenue Service for a tax shelter registration number. The number will be furnished to you when it is received.

(b) A group of persons who could be treated as tax shelter organizers may by agreement designate one person to file Form 8271. If such an agreement is executed, the other organizers will not be subject to penalties for the designated party's failure to file (Q/A-38) UNLESS a signatory knows or has reason to know that the designated party failed to file the Form (Q/A-39). Thus, the utility of such an agreement is, in many cases, minimal.

(c) Section 6112 requires organizers of potentially abusive tax shelters to prepare and maintain a list of investors in the shelters. The requirements are imposed on organizers and sellers of the tax shelter. Any tax shelter that is required to be registered is defined as a potentially abusive tax shelter. 301.6112-1T Q/A-3. The requirements for maintaining, and the information that must be maintained as part of the list are set forth in Temp. Regs. 301.6112-1T.

(d) Upon receipt of the registration number, a tax shelter organizer who registers the tax shelter must provide a copy of the registration notice containing the registration number w/i seven days of its receipt to the principal organizer (if not the party who registered the tax shelter) and any other person the organizer knows or has reason to know is participating in the sale of interests in the tax shelter.

KPMG 003481

Author: Jeffrey Zysik at KPMG_MONT
 Date: 5/20/98 3:10 PM
 Priority: Urgent
 TO: Gregg W. Ritchie at KPMG Warner Center
 CC: Randall S. Nickham at KPMG Silicon Valley2
 CC: Mark A. Springer at KPMG DALLAS4
 CC: Evelyn Elgin
 CC: Mark Watson at KPMG DALLAS4
 Subject: Misc. Tax Reg. issues

----- Message Contents -----

Gregg:

- 1) In the case of OPIS (since it is not a sec. 6111(d) tax shelter) the penalty amount for failure to register is the greater of \$500 or 1 percent of the amount invested in the tax shelter. 6707(a)(2). The liability is joint and several among all persons who had a duty to register. 301.6707-1T Q/A-9. There is no definition of "amount invested" that I could find. Arguably, 301.6111-1T Q/A-13 provides guidance for this definition.
- 2) There is a reasonable cause exception for not registering. See 301.6707-1T Q/A-4 through 7. It is not clear what would provide us with reasonable cause for not registering. However, if we have a colorable argument that 301.6111-1T Q/A-30 applies, and that we are not caught by 301.6111-1T Q/A-31, then perhaps we would have reasonable cause. See the messages between Eve Elgin and myself preliminarily discussing application of Q/A-30 & 31 that I forwarded to you separately.
- 3) Phil Brand did hear back from the Service. They stated that there is very little activity, and they aren't paying much attention to what activity there is.
- 4) Richard Smith pointed out that it is unlikely the Service would attack these transactions as a result of the S264 filing, and that the Service is not in a position to match 1040s with S271s attached to the S264s filings and are unlikely to be in a position to do so in the next decade. Instead, the attack is likely to come should they hear the name of a transaction, at which point they will come directly to us and ask for the identity of all taxpayers who have participated. This is the tactic used in the ACM case. Phil Brand agreed that this is the likely scenario.
- 5) We should consider establishing a separate entity to act as the entity registering ALL tax products if we decide there are a number of transactions that must be registered. Otherwise, we must submit our name as the tax shelter organizer in Part I of the S264. In some cases (eg, perhaps OPIS) our name may also appear as the tax shelter. This would be the case if the "shelter" does not have a TIN of its own (see the S264 instructions). There are some issues with qualifying this entity to serve as the registering agent (it must meet the definition of an organizer so that by agreement among all organizers it will be responsible for registering).
- 6) With respect to the IDV, registration should not have been required since the IDV does not have a tax shelter ratio equal to 2:1 or greater. Tax shelter ratio is defined as "the aggregate amount of deductions and 200 percent of credits . . . potentially available to an investor." 301.6111-1T Q/A-5. "Amount of deductions" is defined as "gross deductions and other similar tax benefits potentially allowable with respect to an investment." 301.6111-1T Q/A-6. Unless you argue that income tax deferral is an "other similar tax benefit[]" the IDV does not have a tax shelter ratio of 2:1 (there is no way the charitable deduction rises to this level). Indeed, this argument should be applicable to any "product" that is a deferral idea (such as the FAT) rather than a deduction generator.
- 7) We should strictly enforce our DO NOT PRELIMINARY DISCUSS THIS PRODUCT WITH TARGETS policy. Under Temp. Treas. Regs. 301.6111-1T Q/A-34 registration must occur by the day on which the first offering for sale of interest in the tax shelter occurs. Q/A-43 states that offering for sale means making any representation, whether oral or written, relating to participation in a tax shelter as an investor. It is possible that this definition applies broadly.

Let me know how else I can assist on this issue.

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 313

KPMG 0034832
 KPMG 0034833

3775

From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=50644
Subject: Larry's Message
Sent: 2002-04-09 14:42:37.335
Date: 2002-04-09 14:42:37.335
X-Folder: Sent Items

How do I respond?

-----Original Message-----

From: Carbo, Deke G
Sent: Tuesday, April 09, 2002 10:36 AM
To: Eischeid, Jeffrey A
Subject: Larry's Message
Importance: High

Jeff:

In responding to Larry's message regarding providing descriptions of other transactions we have done with certain parties (Presidio, Helios, etc.), I am concerned as to what I should tell my clients.

I have two clients who are about to file for 2001. We have discussed with each of them what is happening between KPMG and IRS and both do not plan to disclose at this time. Since Larry's message indicated the information requested was to respond to an IRS summons, I am concerned we are about to turn over a new list of names for transactions I believe IRS has no prior knowledge of. I need to know immediately if that is what is happening. It will obviously have a material effect on their evaluation of whether they wish to disclose and what positions they wish to take on their 2001 returns. Since April 15th is Monday, I need a response.

I am not close to what is happening between KPMG and IRS, but if we are responding to what appears to be an IRS fishing expedition, it is going to reflect very badly on KPMG. Several clients have seriously questioned whether we are doing everything we can to protect their interests.

Deke

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 319

KPMG 0024467

Message4037	
Subject:	RE: Read This Wen... I nee your advice. Fw: TCS Weekly Update
From:	Klein, Wendy (NSS-Tax)
Date:	4/21/2002 7:43:55 PM
To:	Neil, Patricia E
Message Body	
<p>I will talk tomorrow and let you know the results.</p> <p>-----Original Message----- From: Neil, Patricia E Sent: Sunday, April 21, 2002 12:23 PM To: Klein, Wendy (NSS-Tax) Subject: Read This Wen... I nee your advice. Fw: TCS Weekly Update</p> <p>Ken Jones putting us at risk I think. Please advise</p> <p>-----Original Message----- From: Hill, Katherine C (US/NY) <kchill@KPMG.com> To: Neil, Patricia E <pneil@KPMG.com>; Ronda, Jill <jronda@KPMG.com> Sent: Sun Apr 21 07:12:04 2002 Subject: FW: TCS Weekly Update</p> <p>RIPPS OTHELLO and TEMPEST.....our FS clients must be very upset with us.</p> <p>Note that FOCUS is one of PFP Family Office strategies Supposedly we only sold a few "MidCos" about 2 years ago. Insureco was a tough sell but we did have buyers. You know the story on SC2.</p> <p>Kathy</p> <p>-----Original Message----- From: Cavaliere, Christine D Sent: Friday, April 19, 2002 2:41 PM To: Autler, Nancy C; Hill, Katherine C (US/NY) Subject: FW: TCS Weekly Update</p> <p>The second paragraph scares me a little...</p> <p>-----Original Message----- From: Jones, Ken-WASH-DC Sent: Friday, April 19, 2002 2:24 PM</p>	

Proprietary Material
Confidentiality Requested

KPMG 0050430

file://W:\data\J06107583\710\WendyKlien%20HD%20Email\Message4037[44995].html 8/23/2003

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 319

To: Abkin, Wendy; Adelson, Jonathan S; Aland, Robert H; Benda, Jennifer E; Burquest, Patricia L; Click, David L; Collins, Erin M; DePew, Joseph M; Dolan, Michael P; Ely, Mark H; Forster, Miri C; Friedman, Steven M; Galib, Nancy M; Gonzalez, Loida D; Green, Jennifer B; Heroux, Mark S; Howard, Carla A; Katz-pearlman, Sharon D; Kay, Sheldon-ATLANTA M; Lewis, Harve; McCarthy, William B; Miller Jr., Norlyn D; Patterson, Robert E; Quealy Jr., William H; Robeck, Paul G; Roberts, Lauren G (US/WDC-DC); Schneiderman, Paul N; Sherlock, Victoria J; Swann, Deborah; Tombul, Bridget F; Topolka, Paul G
 Cc: Cavaliere, Christine D; Pershouse, William H
 Subject: TCS Weekly Update

Orlando

I suppose we couldn't have picked a worse time to hold our practice meeting ... IRS summonses, the 4/23 Amnesty Disclosure deadline, angry clients, angry KPMG professionals -- and I know that some of you will undoubtedly have to make a call here and there during our meeting. But I actually think we've picked the best time -- we're all stressed, we're busy, we're under a lot of pressures and we need to share our troubles, meet new TCSers, and, as Erin would put it ... "Bond." And bond, we will. We've got a challenging six months ahead of us ... new audit clients (we won Halliburton today) and a boatload of IRS audits for Blips, Opis, Midco, 401k and on and on -- so let's use the two days in Orlando to review where we've been and then get focused on where we are going. (I will try to schedule more of the "where we are going" stuff for early in the meeting because there are some hints that some folks will be in no condition on the second day to focus on anything.)

The "IRS Matter"

We have just hand-carried the lists of investors over to the IRS, for the following deals: MIDCO, FOCUS, INSURECO, OTHELLO, RIPPS/RIPPSS II, SC2, SLOTS, TEMPEST, 357(c), and GLOBAL CURRENCY. Note that not all clients names were turned over for each of these Solutions so if you need to find out if a company or individual was on the list call or email me.

How's the Audit Game Going?

In case you haven't been following the Audit (Assurance) world, Andersen audit clients are dropping like flies. And while KPMG had a slow start in the game, we are starting to win some big ones. Here are two web sites that track the results....FYI.

<<http://www.accountingweb.com/cgi-bin/item.cgi?id=74745>>

<<http://www.forbes.com/2002/03/13/0313andersen.html>>

KEN JONES

Tax Controversy Services

kjones@kpmg.com <<mailto:kjones@kpmg.com>>

tel 202-533-3080

fax 202-533-8553

cell 703-362-1623

kpmg

Proprietary Material
 Confidentiality Requested

KPMG 0050431

3778

Page 3 of 3

Outlook Header Information

Conversation Topic: TCS Weekly Update
Subject: RE: Read This Wen... I nee your advice. Fw: TCS Weekly Update
From: Klein, Wendy (NSS-Tax)
Sender Name: Klein, Wendy (NSS-Tax)
To: Neil, Patricia E
Delivery Time: 4/21/2002 7:43:55 PM
Creation Time: 4/21/2002 7:43:30 PM
Modification Time: 4/21/2002 7:43:55 PM
Submit Time: 4/21/2002 7:43:55 PM
Importance: 4/1
Priority: 4/0
Sensitivity: 4/0
Flags: 4/3
Size: 4/4208

**Proprietary Material
Confidentiality Requested**

KPMG 0050432

file://W:\data\J06107583\710\WendyKlien%20HD%20Email\Message4037[44995].html 8/23/2003

8/23/2003

DeLap, Larry

From: Eischeid, Jeffrey A
 Sent: Friday, January 22, 1999 8:30 AM
 To: Hasting, Carl D
 Cc: Ito, Dennis A; DeLap, Larry; Ammerman, Douglas K
 Subject: RE: Grantor trust reporting

Carl -

I'd be happy to discuss this with you on the phone. I presume you weren't able to make yesterday's CaTS conference call either. On that call, we concluded that each partner must review the WNT memo and decide for themselves what position to take on their returns - after discussing the various pros and cons with their clients.

Jeff

-----Original Message-----

From: Hasting, Carl D
 Sent: Thursday, January 21, 1999 4:18 PM
 To: Eischeid, Jeffrey A
 Cc: Ito, Dennis A
 Subject: FW: Grantor trust reporting

Jeff:

This "debate" between Watson and Gardner affects me in a significant way in that a number of my deals were sold giving the client the option of netting (and living with a 6-year statute) or not netting. Therefore, if they ask me to net, I feel obligated to do so. These sales were before Watson went on record with his position and after the memo had been outstanding for some time.

What is our position as a group? Watson told me he believes it is a hazardous professional practice issue. Given that none of us wants to face such an issue, I need some guidance.

Help???

Carl

-----Original Message-----

From: Watson, Mark T
 Sent: Thursday, January 21, 1999 12:05 PM
 To: Eischeid, Jeffrey A; Baumann, Dale R; Bickham, Randall S; Bloom, Richard J; Branan, Carolyn B; Carbo, Deke G; Fergus, Terrence P; Gardner, John H; Hasting, Carl D; Henderson, Tracie K; Jordan, Robert M; Lison, Shannon L; Nuckolls, John M; Pace, Katherine A; Paule, Robin M; Pedersen, Robert A; Poage, Ray M; Rivkin, David; Slattery, Daniel M; Speiss, Timothy P; Spitz, William L; Tendler, Neil J; Watkins, B M; Wissel, Kyle; Zaudtke, David P; Zysik, Jeffrey C
 Subject: RE: Grantor trust reporting

You should all know that I do not agree with the conclusion reached in the attached memo that capital gains can be netted at the trust level. I believe we are filing misleading, and perhaps false, returns by taking this reporting position.

-----Original Message-----

From: Eischeid, Jeffrey A
 Sent: Thursday, January 21, 1999 2:12 PM
 To: Baumann, Dale; Bickham, Randall; Bloom, Richard; Branan, Carolyn; Carbo, Deke; Eischeid, Jeffrey; Fergus, Terrence; Gardner, John; Hasting, Carl; Henderson, Tracie; Jordan, Robert; Lison, Shannon; Nuckolls, John; Pace, Katherine; Paule, Robin; Pedersen, Robert; Poage, Ray; Rivkin, David; Slattery, Daniel; Speiss, Timothy; Spitz, William; Tendler, Neil; Watkins, B; Watson, Mark; Wissel, Kyle; Zaudtke, David; Zysik, Jeffrey
 Subject: Grantor trust reporting

I believe this is the latest version. Don't forget the statute of limitations issue Tracie raised.

Jeff

3780



**GRANTOR TRUST REPORTING
REQUIREMENTS**

*for
Capital Transaction Strategies*

KPMG Peat Marwick LLP
Washington National Tax

February 1998

Proprietary Material
Confidentiality Requested

KPMG 0010067

GRANTOR TRUST REPORTING REQUIREMENTS

for Capital Transaction Strategies

I. General Rules of Grantor Trusts

A. Overview

IRC Subchapter J, Subpart E, (i.e., sections 671-679) addresses the taxation of grantor trusts and supersedes the general principles of gross income and deductions applicable to trusts.¹ In general, a grantor trust is a transparent entity for income tax purposes. The grantor is treated as owning all items of trust income, deductions, and credit directly, and not as a beneficiary of a trust taxed under the rules of Subchapter J, Subparts A-D. To the extent any portion of a trust is not treated as owned by a grantor or a third person, the trust is taxed under the rules of Subchapter J, Subparts A-D. See Treas. Reg. section 1.671-2(d).

Section 671 contains the general provisions governing the taxation of grantor trusts. Section 672 provides specific definitions and rules regarding grantor trusts. Sections 673-679 define the circumstances in which the income of the trust is taxed to the grantor. Treas. Reg. section 1.671-1(a) provides five general circumstances in which a trust is taxed as a grantor trust.

1. The grantor has retained a reversionary interest in the trust. (Section 673)
2. The grantor or nonadverse party has certain powers over the beneficial interests of the trust. (Section 674)
3. Certain administrative powers over the trust exist under which the grantor can or does benefit. (Section 675)
4. The grantor or nonadverse party has a power to revoke the trust or return the corpus to the grantor. (Section 676)
5. The grantor or nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse. (Section 677)

Proprietary Material
Confidentiality Requested

¹ *Helvering v. Clifford*, 309 US 331 (1940) and *Mallinckrodt v. Numan*, 146 F.2d 1 (8th Cir. 1945) *aff'd* 2 T.C. 1128 (1944)

B. Income Tax Treatment

As stated in section 671, the grantor or other owner of a grantor trust must include in the determination of its tax liability all items of income, deduction and credits, to the extent the grantor is treated as the owner of the trust, as if the grantor had received the items directly. Treas. Reg. section 1.671-2(b) clarifies that the income reported by the grantor is determined by reference to the tax laws under the IRC and not in accordance with trust accounting income, which is normally determined with reference to state law.

The Service has taken the position that the grantor is treated as the owner of the assets and income (or appropriate portion) of a grantor trust. Therefore, transactions occurring between the grantor and the trust are to be ignored for tax purposes. The Service adopted this position when it issued Rev. Rul. 85-13² in opposition to a Second Circuit decision that recognized the trust as a separate tax entity, notwithstanding the grantor trust rules.³ Subsequently, the Service issued Rev. Rul. 87-61⁴ in which it allowed a taxpayer to avoid the section 1491 35 percent excise tax imposed on the appreciation in property transferred to a foreign trust based upon the rationale of Rev. Rul. 85-13. Since the grantor was treated as owning the trust, the excise tax was not imposed at the time the trust was created. However, the ruling did state that the excise tax would be assessed if the grantor renounced his trustee powers that caused the trust to be taxed as a grantor trust.

II. Reporting Requirements

A. General Rules

1. In general, a trust that has at least \$600 of gross income, any taxable income, or a nonresident alien beneficiary must file an annual income tax return (Form 1041) by the 15th day of the fourth month following the end of its taxable year.
2. The reporting requirements for grantor trusts are generally the same. However, as provided in section 671, the grantor must treat all items of income, deduction, and credits, received by a grantor trust as if received directly. Treas. Reg. section 1.671-4 provides guidance on the required income tax reporting of grantor trusts. Treas. Reg. section 1.671-4(a) states that the items reported to a grantor are not reported on Form 1041, but are reported on a separate statement attached to Form 1041.

Proprietary Material
Confidentiality Requested

² 1985-1 C.B. 184

³ *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984)

⁴ 1987-2 C.B. 219

3. The information at the top of page 1 of Form 1041 must be completed and the box for "Grantor type trust" checked. The items of income, deduction, and credit attributable to the portion owned by the grantor or other person are reported on a separate statement attached to Form 1041. The fiduciary is required to furnish the same information to the grantor. Schedule K-1 is not required.

B. Alternative Methods

Treas. Reg. section 1.671-4(b) provides two alternative methods for reporting all items of income, deduction and credit to the grantor of a grantor trust. However, it is assumed that the trustee will report the items of income, deduction and credit on a separate statement attached to Form 1041, as provided in Treas. Reg. section 1.671-4(a). For further discussion of the two alternative reporting requirements, see Appendix A attached to this outline.

C. Form 1041 Instructions

With respect to grantor trusts, the Form 1041 instructions explain: "[r]eport on Form 1041 only the part of the income that is taxable to the trust. Do not report on Form 1041 the income that is taxable to the grantor or another person. Instead, attach a separate sheet to report:

- The income of the trust that is taxable to the grantor or another person under sections 671 through 678;
- The name, identifying number, and address of the person(s) to whom the income is taxable; and
- Any deductions or credits applied to this income.

The income taxable to the grantor or another person under sections 671 through 678 and the deductions and credits applied to the income must be reported by that person on his or her own income tax return."

D. Reporting Capital Gains and Losses

1. Other than examples provided in Treas. Reg. section 1.671-4(b)(2)(iv), the regulations provide no additional guidance on the reporting of capital transactions for grantor trusts. The examples are referenced in the attached Appendix A at I., C. Both examples disclose the gross proceeds and date of sale; therefore, it appears that this is the minimum required information that must be provided to the grantor if the trustee elects to report under Treas. Reg. section 1.671-4(b)(2). However, there is no specific requirements on reporting the net capital gain or loss from all transactions of the trust. The example in Treas. Reg. section 1.671-

Proprietary Material
Confidentiality Requested

4(b)(2)(iv)(B) simply states "Gain from sale of B Stock." Therefore, this can be interpreted to provide for a netting of all gains and losses to be reported to the grantor, since the other information related to the stock sale in the example would allow the grantor to calculate the gain or loss without having a separate disclosure of the gain.

2. Since there is no other direct guidance on point, the Service's interpretation of the reporting of capital gains and losses to taxpayers in connection with other pass-through entities may serve as alternative guidance.

- a. **Trusts.** For non-grantor trusts, the capital gains and losses are typically taxed to the trust and are not reported to the trust beneficiaries. However, situations do arise whereby capital gains or losses are passed out to the trust beneficiaries. Section 661 and the regulations thereunder state that the character of the amounts being passed to the beneficiaries is generally based upon the amount of each item in proportion to the total distributable net income of the trust. However, this general rule can be modified by the trust's governing instrument.

In interpreting section 661 and the corresponding regulations, the Service has provided a Schedule K-1 (Form 1041) to report each beneficiary's share of income, loss deduction or credit. The Schedule K-1 reports the net short-term capital gain separately from the net long-term capital gain.

- b. **Partnerships.** Since a partnership is not subject to tax, the taxable items of a partnership are reported to its partners. Section 702(a) states that a partner must take into account the following items in determining the partner's taxable income and tax liability.
 - (1) Gains and losses from the sales or exchanges of capital assets held for not more than 1 year.
 - (2) Gains and losses from the sales or exchanges of capital assets held for more than 1 year.
 - (3) Gains and losses from sales or exchanges of property described in section 1231.
 - (4) Charitable contributions.
 - (5) Dividends with respect to which there is a deduction under part VIII of Subchapter B.

Proprietary Material
Confidentiality Requested

- (6) Taxes, described in section 901, paid or accrued to foreign countries and to possessions of the US.
- (7) Other items of income, gain, loss, deduction, or credit, to the extent provided by regulations.
- (8) Taxable income or loss, exclusive of the items requiring separate computation (i.e., those stated above).

In connection with the application of section 702(a) and the regulations thereunder, the Service has provided a Schedule K-1 (Form 1065) to report each partner's share of income, loss deduction or credit. As required by sections 702(a)(1) and (2), the Schedule K-1 reports the net short-term capital gain separately from the net long-term capital gain.

- c. **S Corporations.** Section 1366(a)(1) requires the shareholder(s) of an S corporation to take a pro rata share of the corporation's items of income, including tax-exempt income, loss, deduction, or credit that would affect the tax liability of the shareholder. Additionally, section 1366(b) states that the character of any item included in the shareholder's pro rata share under section 1366(a)(1) shall be determined if such item was realized directly by the corporation, or incurred in the same manner as the corporation.

In connection with section 1366 and the regulations thereunder, the Service has provided a Schedule K-1 (Form 1120S) to report each shareholder's share of income, loss deduction or credit. The Schedule K-1 reports the net short-term capital gain separately from the net long-term capital gain.

III. Reporting Position for Capital Gain Transactions

A. Capital Gain Netting

A reporting position exists whereby the net short-term capital gain/loss and net long-term capital gain/loss can be netted at the grantor trust level. Therefore, only a net short-term gain/loss or net long-term gain/loss will be reported to the grantor. The trustee will also supply all details of the capital transactions to the grantor. However, rather than reporting the net gain or loss from short-term transactions separately from long-term, they will be reported to the grantor as a single gain or loss amount to be included by the grantor on his or her tax return.

Section 671 requires the trustee to report all items of income, loss and deduction to the grantor. The trustee will have met this requirement by providing all

Proprietary Material
Confidentiality Requested

transaction details to the grantor. However, for simplicity purposes, the trustee may report a net gain or loss to the grantor for preparing its income tax return.

1. **Regulatory Authority.** The examples in Treas. Reg. section 1.671-4(b)(2)(iv) appear to allow the trustee to report the capital transactions to the donor in this manner. As stated in Example 2(ii)(B) of (b)(2)(iv), the trustee must report the "Gain from sale of B stock." Since the trustee is also providing complete cost and sales information, the determination of the capital gain would appear to be for the convenience of the grantor. Furthermore, if the trustee is required to provide the grantor with the proceeds, basis, acquisition date and date of sale for each transaction, it would appear unnecessary for the trustee to provide the grantor with a calculation of the net gain or loss from each transaction. Thus, it appears that the Service contemplated the netting of gains and losses.

In contrast, the Service has interpreted the requirement to provide the taxpayer of a pass-through entity with separate short-term and long-term gains and losses (i.e., trusts, partnership, and S corporations). However, there are distinctions that can be made with respect to grantor trusts. In connection with non-grantor trusts, section 661 and Treas. Reg. section 1.661(b)-1 state that the income distributed to the beneficiary must be of the same proportionate character as the total distributable income of the trust. For partnerships, section 702(a) specifically states that the partnership must report net short-term gains and losses separate from net long-term gains and losses. The S corporation reporting requirements are similar to those of non-grantor trusts. Section 1366(a)(1) requires the shareholder of an S corporation to take a pro rata share of the corporation's items of income, including tax-exempt income, loss, deduction, or credit. Additionally, section 1366(b) states that the character of any item included in the shareholder's pro rata share under section 1366(a)(1) shall be determined if such item were realized directly by the corporation.

With the other pass through entities, the Service has either been specifically directed or has interpreted the statute as requiring net short-term capital gains and losses be reported separate from net long-term capital gains and losses. However, since the code and regulations for these entities are not identical to Treas. Reg. section 1.671-4, and since they are not referenced therein, it is not conclusive that the trustee must report net short-term capital gains and losses separately from net long-term capital gains and losses.

2. **Tax Forms and Instructions.**

Proprietary Material
Confidentiality Requested

- a. Form 1041 Instructions. As stated above, the Form 1041 instructions provide that in connection with a grantor trust, "attach a separate sheet to report:

- The income of the trust that is taxable to the grantor or another person under sections 671 through 678;
- The name, identifying number, and address of the person(s) to whom the income is taxable; and
- Any deductions or credits applied to this income.

The income taxable to the grantor or another person under sections 671 through 678 and the deductions and credits applied to the income must be reported by that person on his or her own income tax return.

The language above focuses on income "taxable" to the grantor. Taxable income under the principles of section 63(a), 165(f), and 1211(b) can be defined as including the net gain or loss from the disposition of capital assets.

- b. Schedule D of Form 1040.

Line 5 of the 1997 Schedule D of Form 1040 requests net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1. Line 12 contains a similar description in connection with net long-term gain. The grantor trust attachment is essentially a substitute K-1. See the discussion under penalties that follows.

3. **Penalties.** Treas. Reg. section 1.671-4(f) provides for the assessment of penalties against the trustee for a failure to file a correct Form 1099 or a correct information statement. A trustee's failure to provide the grantor with a correct Form 1099 or statement as provided for in Treas. Reg. section 1.671-4(b) is subject to the penalties imposed by IRC sections 6721 and 6722 and the regulations thereunder.

- a. **Section 6722.** It could be argued that the penalties imposed by section 6722 should not apply to the method of reporting that is the subject of the memorandum because Treas. Reg. section 1.671-4(f) refers to the method referred to in Treas. Reg. section 1.671-4(b) and not in Treas. Reg. section 1.671-4(a). However, the separate statement to be attached to Form 1041 is likely to be considered a payee statement for purposes of section 6722. Section 6724(d)(2)(A) provides that the term payee statement means any

Proprietary Material
Confidentiality Requested

statement required to be furnished under section 6034A. Section 6034A(a) provides that the fiduciary of any estate or trust required to file a return shall furnish to each beneficiary who receives a distribution or is allocated income a statement containing such information.

- b. Section 6722 imposes a penalty for failing to furnish correct payee statements. For each failure (i.e., failure to include all of the required information on the statement, or the inclusion of incorrect information), the payor is assessed a \$50 penalty. However, if the payor is found to have a failure that is due to an intentional disregard of the requirement to furnish a payee statement, additional penalties may be imposed.
 - (1) The penalty is increased to \$100 per statement, or, if greater, 10 percent of the aggregate amount of the items required to be reported correctly, except statements required under sections 6045(b), 6041A(e), 6050H(d), 6050J(e), 6050K(b) or 6050L(c), none of which apply to grantor trusts.
 - (2) If the penalty for intentional disregard is assessed, the \$100,000 limitation under section 6722(a) will not apply, and the penalty shall not be taken into account in applying such limitation to other penalties for failing to furnish correct payee statements.
 - (3) Unless the Service was successful in arguing that the penalty for intentional disregard applied, the penalty exposure for the trustee is \$50 per grantor statement. It is unlikely that the penalty for intentional disregard would apply. Given the lack of clarity of the reporting requirements of Treas. Reg. section 1.671-4, there would not appear to be an intentional disregard of the reporting requirements. As discussed above, capital gain information will be reported on a net basis. Reporting on that basis is not inconsistent with providing information regarding income taxable to the grantor.
- c. Section 6662. Section 6662 penalties could be assessed against the grantor if the netting of the short-term and long-term capital gains and losses by the grantor trust caused the grantor to underpay income tax. The only situation in which this would arise is when the grantor trust offsets a net long-term capital loss with a net short-term capital gain, and the grantor has other long-term capital gains outside of the grantor trust. In this situation, the grantor will

Proprietary Material
Confidentiality Requested

have underreported the net short-term capital loss on his income tax return and overstated his net long-term capital gain. If the trustee had not netted the gains at the trust level, the long-term losses would have reduced the long-term capital gains outside the grantor trust, before reducing the short-term capital gain from within the trust. With the difference in tax rates for short-term capital gains versus long-term capital gains (see section 1), an understatement of net short-term capital gains would cause the grantor to underreport his or her tax liability.

In most situations the trust will be offsetting net short-term capital losses with net long-term capital gains. In these situations, it is possible that the grantor will overstate his tax liability, if he has other short-term capital gains outside the trust. If the short-term capital loss was not offset against the long-term capital gain by the trust, the short-term capital loss may completely eliminate any short-term capital gains outside the trust, and minimize the reduction in the long-term capital gain. Thus, the grantor may overstate the short-term capital gain, causing an overstatement of the tax liability.

- d. **Reporting to Grantor.** Given the possibility of the grantor reporting an incorrect tax liability as a result of the trustee's netting of short-term and long-term capital gains and losses, the information should be separately provided to the grantor. It is recommended that all of the transactions be reported to the grantor, as a supplement to the grantor trust letter, for the grantor to have the information to calculate the correct tax liability.

B. Individual Return Preparation.

Although not intended to be the focus of this paper, a logical question will arise after the completion of the grantor trust tax return regarding the filing of the grantor's individual income tax return. Of particular concern is the treatment of the net capital gain or loss when there are other net short-term capital gains outside of the grantor trust. There appears to be two alternatives to handle these situations.

1. The taxpayer should be alerted to the possible incorrect reporting of the income tax liability. If the taxpayer so directs, we could prepare the return with the net long-term capital gain as reported from the grantor trust combined with the short-term capital gains from outside the trust. Although the tax liability would be incorrectly stated, the taxpayer would be overpaying the income tax liability and, therefore, not be subject to the section 6662 penalties which are assessed for an underpayment of tax liability. KPMG would still be able to sign the return, even though the tax

**Proprietary Material
Confidentiality Requested**

liability is overstated. This is similar to the taxpayer instructing us to ignore certain legitimate deductions (i.e., the charitable deduction from an Investment Diversification Vehicle, unreimbursed business expenses, etc.) based on the taxpayer's desire not to call attention to certain transactions or those which are frequently questioned by the IRS.

2. In cases where the netting of grantor trust transactions with transactions outside the grantor trust, the grantor should be provided with all of the detail of the capital transactions with the grantor trust letter. With this information, the preparer could report capital gains and losses on the individual return to correctly calculate the tax liability.

IV. Conclusion

In connection with the information reporting of a grantor trust, net short-term capital losses may be netted with net long-term capital gains on the information statement provided by the trustee to the grantor. The avoidance of penalties is further enhanced if the grantor is also the trustee or co-trustee of the trust. The following is the suggested reporting for selected grantor trusts.

- A. The trustee will file under Treas. Reg. section 1.671-4(a).
- B. The net short-term capital gains and losses will be netted with the net long-term capital gains and losses to report one net gain or loss (short-term or long-term) to the grantor.
- C. The copy of the 1041 filed with the IRS will not contain a detailed statement of the capital transactions and will have the following notation on page one of Form 1041.

"Pursuant to Treas. Reg. Sec. 1.671-4(a), items of income, deduction, and credit attributable to a grantor trust under IRC Secs. 671-678 are reported on the attached separate statement."

- D. The information statement provided to the grantor will report one net gain or loss (short-term or long-term) to the grantor.
- E. The transaction detail should be provided on the transmittal letter or on a separate attachment referenced on the transmittal letter to the grantor. A statement should be included in the transmittal letter similar to the following:

"If you have other capital transactions outside of this trust, the additional information provided in [this letter] [Attachment B] may be required to correctly calculate your income tax liability."

Proprietary Material
Confidentiality Requested

APPENDIX A

- I. Treas. Reg. section 1.671-4(b)(2)(i) provides two alternative methods of reporting for a grantor trust which is treated as owned by a single grantor.
 - A. The trustee can "furnish the name and taxpayer identification number (TIN) of the grantor or other person as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii)." (Treas. Reg. section 1.671-4(b)(2)(i)(A))
 1. Treas. Reg. section 1.671-4(b)(2)(ii)(A) imposes additional obligations on the trustee when the name and TIN of the grantor and address of the trust are furnished to payors. The statement provided to the grantor must include the following.
 - a. Shows all items of income, deduction, and credit of the trust for the taxable year.
 - b. Identifies the payor of each item of income.
 - c. Provides the grantor with the information necessary to take the items into account in computing the grantor's taxable income.
 - d. Informs the grantor that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor.
 2. If the trustee chooses the option under Treas. Reg. section 1.671-4(b)(2)(i)(A), the trustee is not required to file any type of return with the IRS. (Treas. Reg. section 1.671-4(b)(2)(ii)(B))
 - B. The trustee can "furnish the name, TIN and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii)." (Treas. Reg. section 1.671-4(b)(2)(i)(B))
 1. Treas. Reg. section 1.671-4(b)(2)(iii)(A) imposes an additional obligation on the trustee to file the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the taxable year and showing the trust as the payor and the grantor as the payee.
 - a. Under this alternative, the trustee has the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately.

Proprietary Material
Confidentiality Requested

- b. Treas. Reg. section 1.671-4(b)(5) states that the information reporting requirements only include those amounts that would otherwise be reported to the trustee on Form 1099. Thus, any items of income that would be reported from partnership, S corporation or trust Schedules K-1 are not included in the information reporting requirements of this regulation.
- 2. Treas. Reg. section 1.671-4(b)(2)(iii)(B) defines the reporting obligations of the trustee when the name and TIN of the grantor and address of the trust are furnished to payors. The statement provided to the grantor must include the following.
 - a. Shows all items of income, deduction and credit of the trust for the taxable year.
 - b. Provides the grantor with the information necessary to take the items into account in computing the grantor's taxable income.
 - c. Informs the grantor that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor's income tax return.
- C. Treas. Reg. section 1.671-4(b) provides examples on the alternative reporting methods outlined in Treas. Reg. section 1.671-4(b)(2)(ii)(A) and Treas. Reg. section 1.671-4(b)(2)(ii)(B).
 - 1. Treas. Reg. section 1.671-4(b)(2)(iv) provides two examples of the reporting requirements for a trust electing to report under section Treas. Reg. section 1.671-4(b)(2)(ii)(B). In Example 2, the trustee reports the items of interest, dividends and gain from the sale of stock. In reporting the gain from the sale of stock, the example lists the information provided with relation to the sale of stock to include the proceeds, basis, acquisition date, and the date the stock was sold. If the trustee did not acquire the stock sold nor has the basis and acquisition date, the regulations provide an alternative reporting method. Under the alternative method, the trustee does not report the gain from the sale of stock, the basis, nor the acquisition date. However, the trustee must still report the gross proceeds and the date of sale.

Proprietary Material
Confidentiality Requested

2. Treas. Reg. section 1.671-4(b)(5)(ii) provides an example of the Form 1099 filing requirements of the trustee. This example is limited to the reporting requirements related to the Forms 1099 and does not provide any further examples of the reporting requirements regarding capital gains and losses.
- II. The instructions for Form 1041 mirror the requirements of Treas. Reg. section 1.671-4(b)(2). Although the instructions do not carry the weight of law under the IRC or Treasury Regulations, the instructions reflect the Service's interpretation of the IRC and the regulations. The 1041 instructions list two alternative methods for reporting information related to a grantor trust for trusts with only one grantor.
- A. **Method 1.** The trustee must give the payors of all income during the year the name and TIN of the grantor and the address of the trust. However, this method may only be used if the grantor provides the trustee with a completed and signed Form W-9, Request for Taxpayer Identification Number. Additionally, the trustee is required to provide the grantor a statement with the following information, unless the grantor is the trustee or co-trustee of the trust.
 1. Shows all items of income, deduction and credit of the trust.
 2. Identifies the payor of each item of income.
 3. Explains how the grantor takes those items into account when figuring the grantor's taxable income or income tax liability.
 4. Informs the grantor or other person treated as the owner of the trust that those items must be included when figuring taxable income and credits on his or her income tax return.
 - B. **Method 2.** The trustee must give the payors of all income during the year the name, TIN, and address of the trust. The trustee must also file the appropriate Forms 1099 to report the income and gross proceeds paid to the trust during the tax year, and the Forms 1099 will show the trust as the payor and the grantor as the payee. The trustee is also required to report each type of income in the aggregate and each item of gross proceeds separately. Additionally, unless the grantor is the trustee or co-trustee of the trust, the trustee must provide the grantor with a statement with the following information, which also can satisfy the requirement to provide the grantor with copies of the Forms 1099 filed by the trustee.
 1. Shows all items of income, deduction and credit of the trust.
 2. Explains how the grantor takes those items into account when figuring the grantor's taxable income or income tax liability.

Proprietary Material
Confidentiality Requested

3. Informs the grantor or other person treated as the owner of the trust that those items must be included when figuring taxable income and credits on his or her income tax return.
- III. Treas. Reg. section 1.671-4(b)(6) lists the six types of trusts that are not allowed to use the reporting methods of Treas. Reg. section 1.671-4(b).
- A. A common trust fund described in section 584(a).
 - B. A trust that has its situs or any of its assets located outside the U.S.
 - C. A trust that is a qualified subchapter S trust under section 1361(d)(3).
 - D. A trust with a grantor whose taxable year is a fiscal year.
 - E. A trust with a grantor who is not a U.S. person.
 - F. A trust which has two or more grantors, one of whom is not a U.S. person.

Proprietary Material
Confidentiality Requested

3795

new

From: Watson, Mark T
Sent: Wednesday, September 02, 1998 4:24 PM
To: Gardner, John H; Etcheld, Jeffrey A
Cc: Henderson, Trace K; Elgin, Evelyn; Randall S Bickham at KPMG_Silicon_Valley2; Perez, Robert L
Subject: RE: FW: Grantor trust memo

Notwithstanding the conclusion reached in the "grantor trust memo," I don't think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust returns/statements only for certain clients? When you put the OPIS transaction together with this "stealth" reporting approach, the whole thing stinks.

-----Original Message-----
From: Gardner, John H
Sent: Wednesday, September 02, 1998 4:19 PM
To: Etcheld, Jeffrey A
Cc: Henderson, Trace K; Watson, Mark T; Elgin, Evelyn; Randall S Bickham at KPMG_Silicon_Valley2
Subject: RE: FW: Grantor trust memo

Jell:

Carl Hasting told me that an attorney he was dealing with just raised an issue with 6501(e) and the possibility that the netting could create a 6-year statute. I would argue that Reg. sec. 301.6501(e)-1(a)(1)(i) states the general rule that applies if the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code AN AMOUNT PROPERLY INCLUDEABLE THEREIN (emphasis added) which is in excess of 25 percent of the gross income so stated. . . . The amount properly includible on Schedule D, lines 5 and 12, is the net short-term or long-term gain or loss from a trust's K-1. The grantor trust attachment that is filed pursuant to Reg. sec. 1.671-4(a) is essentially a substitute K-1, thus the net amount from the trust's K-1 would be the amount properly includible on the return.

What do you think? For less aggressive taxpayers, note that 6501(e)(1)(A)(ii) provides an exclusion for amounts omitted from gross income stated in the return if such amount is disclosed in the return, or a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item. Since a six year statute for this transaction is not a good answer, we may want to consider some way of providing the details in an understated way.

John

Reply Separator

Subject: FW: Grantor trust memo
Author: Jeffrey A Etcheld at KPMG_US
Date: 9/1/1998 7:45 PM

-----Original Message-----
From: Henderson, Trace K
Sent: Tuesday, September 01, 1998 1:38 PM
I think this is great and I agree with the analysis and conclusions. Are you comfortable mentioning this on tomorrow's conference call and posting it on the KMan workgroup in the OPIS toolkit? People are trying to get their tax returns

1

Proprietary Material
Confidentiality Requested

KPMG 0035807

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 321

3796

out the door, as well as plan '98 transactions.

Jeff

To: Eischard, Jeffrey A
Subject: FW: Grantor trust memo

lyl

-----Original Message-----
From: Gardner, John H
Sent: Monday, August 31, 1998 7:40 AM
To: Henderson, Tracie K
Subject: Grantor trust memo

Tracie:

I sent this to Gregg a while ago with the understanding that he would circulate it among the CaTS team for comments. I believe this is the latest version.

John

2

Proprietary Material
Confidentiality Requested

KPMG 0035808

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=9905
 From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=9905
 To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
 Subject: FW: Grantor trust memo
 Sent: 1998-09-10 13:45:42.133
 Date: 1998-09-10 13:45:42.226
 X-Folder: Grantor Trust

Jeff -

My preference would be to provide all necessary detail to the grantor: date purchased, date sold, cost and proceeds on an attachment that's included in the 1041. The summary page would show the net. That way, we have given the taxpayer what he requires to file an accurate return. Accordingly, any netting is "really" done at the 1040 level. But, we have a better argument for doing the netting that we would if we had no grantor trust.

Tracie

-----Original Message-----

From: Eischeid, Jeffrey A
 Sent: Tuesday, September 08, 1998 9:14 AM
 To: Henderson, Tracie K
 Subject: FW: FW: Grantor trust memo

-----Original Message-----

From: Watson, Mark T
 Sent: Thursday, September 03, 1998 1:50 PM
 To: Eischeid, Jeffrey A
 Cc: Gardner, John H
 Subject: RE: FW: Grantor trust memo

Jeff, yes, there are several reasons I disagree with the memo's logic. Specifically, section 671, Reg. section 671-1, -2, and -3, several court cases, Rev. Rul. 85-13, and numerous private letter rulings make it very clear that if a grantor or another person is treated as the owner of a trust, "he [or she] takes into account in computing his [or her] income tax liability all items of income, deduction, and credit . . . to which he [or she] would have been entitled had the trust not been in existence during the period he is treated as the owner." See Reg. section 1.671-3(a)(1). In other words, the grantor is treated as if he or she owned the trust's assets. Clearly, if the grantor directly sold one stock that generated a long-term capital gain, and, in the same year, directly sold another stock that generated a short-term capital loss, the grantor could not net the short-term loss against the long-term gain and report only the net gain or loss on his or her tax return. Rather, he or she would have to report each transaction separately on Schedule D.

Why then, when the above mentioned authority makes it clear that a grantor who is treated as the owner of a trust is treated as if he or she owned the trust's assets, would we reach a conclusion that we can net gains and losses at the grantor trust level? The "grantor trust memo" answers this question basically by stating "there is nothing that explicitly says we can't net." However, I argue that Treasury did not need to specifically address this matter because it is abundantly clear -- a grantor who is treated as the owner of a trust is deemed to own the trust's assets, and if he or she is deemed to own the trust

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 321

KPMG 0023331

assets, then reportable transactions related to those assets must be reported in the same manner as they would if grantor actually did own the assets (i.e., no netting).

Further, to my knowledge, KPMG (and I suspect every other accounting firm) has never netted on grantor trust returns. In fact, as the memo points out, you can get the wrong tax liability by netting on a grantor trust return. Thus, in response your second question, we cannot adopt netting on a broad-based basis because we would not be giving our clients sufficient information to prepare an accurate tax return if we did.

All the relevant evidence (e.g., the Code, regulations, case law, IRS rulings, partnership rules, S corporation rules, etc.) leads to the rational conclusion that you cannot net on a grantor trust return. Thus, I disagree with the conclusion reached in the memo.

-----Original Message-----

From: Eischeid, Jeffrey A
Sent: Wednesday, September 02, 1998 7:34 PM
To: Watson, Mark T
Subject: RE: FW: Grantor trust memo

Is there a particular reason you disagree with the memo's logic? I don't want our people reporting in an inappropriate manner.

If we were to adopt the approach on a broad-based, go-forward basis are you more comfortable? In other words, what if we use the netting approach w/r/t trusts that didn't have an OPIS transaction in them as well as those that did?

Jeff

-----Original Message-----

From: Watson, Mark T
Sent: Wednesday, September 02, 1998 7:24 PM
To: Gardner, John H; Eischeid, Jeffrey A
Cc: Henderson, Tracie K; Elgin, Evelyn ; 'Randall S Bickham at KPMG Silicon Valley2'; Perez, Robert L
Subject: RE: FW: Grantor trust memo

Notwithstanding the conclusion reached in the "grantor trust memo," I don't think netting at the grantor trust level is a proper reporting position. Further, we have never prepared grantor trust returns in this manner. What will our explanation be when the Service and/or courts ask why we suddenly changed the way we prepared grantor trust returns/statements only for certain clients? When you put the OPIS transaction together with this "stealth" reporting approach, the whole thing stinks.

-----Original Message-----

From: Gardner, John H
Sent: Wednesday, September 02, 1998 4:19 PM
To: Eischeid, Jeffrey A
Cc: Henderson, Tracie K; Watson, Mark T; Elgin, Evelyn ; Randall S Bickham at KPMG Silicon Valley2
Subject: RE: FW: Grantor trust memo

Jeff:

Proprietary Material
Confidentiality Requested

KPMG 0023332

Carl Hasting told me that an attorney he was dealing with just raised an issue with 6501(e) and the possibility that the netting could create a 6-year statute. I would argue that Reg. sec. 301.6501(e)-1(a)(1)(i) states the general rule that applies if the taxpayer omits from the gross income stated in the return of a tax imposed by subtitle A of the Code AN AMOUNT PROPERLY INCLUDIBLE THEREIN (emphasis added) which is in excess of 25 percent of the gross income so stated . . . The amount properly includible on Schedule D, lines 5 and 12, is the net short-term or long-term gain or loss from a trust's K-1. The grantor trust attachment that is filed pursuant to Reg. sec. 1.671-4(a) is essentially a substitute K-1, thus the net amount from the trust's K-1 would be the amount properly includible on the return.

What do you think? For less aggressive taxpayers, note that 6501(e)(1)(A)(ii) provides an exclusion for amounts omitted from gross income stated in the return if such amount is disclosed in the return, or a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item. Since a six year statute for this transaction is not a good answer, we may want to consider some way of providing the details in an understated way.

John

Reply Separator

Subject: FW: Grantor trust memo
 Author: Jeffrey A Eischeid at KPMG_US
 Date: 9/1/1998 7:45 PM

-----Original Message-----

From: Henderson, Tracie K
 Sent: Tuesday, September 01, 1998 1:38 PM
 I think this is great and I agree with the analysis and conclusions. Are you comfortable mentioning this on tomorrow's conference call and posting it on the KMan workgroup in the OPIS toolkit? People are trying to get their tax returns out the door, as well as plan '98 transactions.

Jeff

To: Eischeid, Jeffrey A
 Subject: FW: Grantor trust memo

fyi

-----Original Message-----

From: Gardner, John H
 Sent: Monday, August 31, 1998 7:40 AM
 To: Henderson, Tracie K
 Subject: Grantor trust memo

Tracie:

Proprietary Material
 Confidentiality Requested

KPMG 0023333

3800

I sent this to Gregg a while ago with the understanding that he would circulate it among the CaTS team for comments. I believe this is the latest version.

John

kpmg Peat Marwick LLP

To Robin Paule

Date December 21, 1998

From Bob Simon / Margaret Lukes

Steno ml

Ref p:\users\vpaulw\wp\cats\opis\reptrng.doc

Certain U.S. International Tax Reporting Requirements re: OPIS

This memorandum discusses certain U.S. international tax reporting requirements relevant to a U.S. investor's ("Investor") participation in the Offshore Portfolio Investment Strategy ("OPIS"). It should be noted that this memorandum pertains only to potential reporting requirements on Form 5471 and Form 8621 and does not address other reporting requirements that may apply. In preparing this memorandum, we have not been asked to review and/or agree with the conclusions reached in the OPIS opinion. Accordingly, for purposes of this memorandum, we have assumed that the conclusions reached in the OPIS opinion are correct. If, for any reason, the conclusions are not correct, the reporting requirements would almost certainly change.

Facts:

We understand the OPIS strategy is as follows:

Structure

Investor is a U.S. individual (or a U.S. entity or trust that is owned by a U.S. individual). A foreign taxpayer unrelated to Investor ("Foreign Partner") owns a 90 percent limited partnership interest in a Cayman Islands limited partnership ("Foreign LP").¹ Foreign LP elects to be treated as a corporation for U.S. tax purposes. This election is effective as of the first day of Foreign LP's legal existence.² A Cayman Islands exempted company ("Exempt Company") that is wholly-owned by Foreign Partner is the 10 percent general partner. Exempt Company is considered a corporation for U.S. tax purposes. We understand that Investor does not own any interests in Foreign LP or Exempt Company (or Foreign Partner) that would be characterized as equity for U.S. tax purposes.

¹ Alternatively, the foreign taxpayer may own 100 percent of a Delaware LLC which would be treated as a branch for U.S. income tax purposes. The Delaware LLC would own the 90 percent limited partnership interest in Foreign LP. We understand that none of Foreign Partner, Foreign LP or Exempt Company will be engaged in a U.S. trade or business.

² Note that if Foreign LP is not characterized as a corporation from its inception for U.S. tax purposes and if the swap agreement is treated as an equity interest in Foreign LP, Investor potentially could have reporting requirements under Code §6046A and Prop. Reg. §1.6046A-1. In addition, there may be reporting requirements under newly issued proposed regulations relating to transfers to foreign partnerships and controlled foreign partnerships. See Prop. Reg. §§1.6038B-2 and 1.6038-3.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 324

KPMG 0050630

kpmg Peat Marwick LLP

Page 2
Robin Paule
August 20, 2003

For purposes of this memorandum, we assume that neither Investor nor any other U.S. shareholder (1) have the power to elect, appoint, or replace a majority of the board of directors of either foreign corporation, (2) have the power to break a deadlock where such U.S. shareholders have the power to elect exactly one-half of the directors of either foreign corporation, or (3) have the power to elect, appoint, or replace a sole "manager" of either foreign corporation who exercises the powers ordinarily exercised by a board of directors. We also assume that neither Investor nor any other U.S. person is an officer or director of either foreign corporation and that neither Investor nor any other U.S. person possess practical control of either foreign corporation through a formal or informal agreement. If any of these assumptions are not correct, the reporting requirements likely will change.

Relevant Events

1. In general, Investor will enter into a total return swap with Foreign Partner. The swap agreements entered into by various Investors may contain different terms and will have to be analyzed on a case-by-case basis. However, based on the OPIS opinion and on representation made by the OPIS working group, none of the swap agreements will cause Investor to be treated as owning an equity interest in Foreign LP.³
2. Investor purchases (for fair market value) a call option from Foreign Partner to acquire 50 percent of Foreign Partner's interest in Exempt Company. We have assumed that the option would be treated as an option for U.S. federal income tax purposes.
3. Foreign LP acquires shares in Foreign Bank. Foreign Bank may later redeem these shares. If such redemption were to occur, Investor may simultaneously purchase options to acquire the same number of shares Foreign LP previously owned directly.

Conclusions:

³ Assuming Investor's payments to Foreign Partner under the swap agreement are part of a taxable exchange, the payments should not result in a reporting requirement under Code §6038B.

kpmgPeat Marwick LLP

Page 3
Robin Paule
August 20, 2003

As discussed below, Investor generally should not have Form 5471 or Form 8621 reporting requirements with respect to its interests in Exempt Company and Foreign LP.

- Assuming that Investor holds an option to acquire no more than 50 percent of Exempt Company, and assuming that no other U.S. person owns an interest (directly, indirectly, or constructively) in Exempt Company, the option in and of itself should not cause Investor to have a Form 5471 filing requirement. The specific Form 5471 requirements with respect to Exempt Company are discussed below.
- Assuming that the swap agreement does not cause Investor to be treated as owning an equity interest in Foreign LP (as discussed in the OPIS opinion), Investor should not have a Form 5471 filing requirement.⁴ The specific requirements are discussed below.
- Both Exempt Company and Foreign LP likely would be considered passive foreign investment companies. Since Investor is not a direct or indirect shareholder in either Exempt Company or Foreign LP, there generally should be no income inclusion under the current PFIC rules and no reporting requirement.

With respect to Exempt Company, proposed regulations generally require an option holder to report a disposition of an option (other than through exercise of the option) with respect to stock of a PFIC on Form 8621. However, neither the Internal Revenue Code ("Code"), nor temporary or final regulations require such reporting. Therefore, Washington National Tax believes that a U.S. person that merely holds an option to acquire stock of a PFIC may take the position that no Form 8621 reporting is required on the disposition of such option. However, because the proposed regulations have a retroactive effective date, if they are finalized (with the same effective date) before the statute of limitations on the tax year closes, Investor should under such circumstances consider filing an amended return with respect to its option on the shares of Exempt Company.

Discussion:

⁴ If the swap agreement does result in an equity interest, Investor would likely have a Form 5471 reporting requirement with respect to Foreign LP as a category 2 and 4 filer.

kpmg Peat Marwick LLP

Page 4
 Robin Paule
 August 20, 2003

Form 5471 Reporting

Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, should be used to meet the reporting requirements imposed by Code §§6035, 6046, 6038 and 964(c) as discussed below.

A \$10,000 penalty applies for each failure to file Form 5471 or provide required information. Code §6038(b) and Code §6679. This penalty may be increased to a maximum of \$50,000 for each such failure if the failure continues after notification. A taxpayer may be relieved from these penalties under a reasonable cause exception provided by Reg. §1.6038-2(k)(3)(iii) and Reg. §1.6679-1(a)(3). To show that reasonable cause existed for failure to furnish information required by Code §§6035, 6038, and 6046, the person required to report such information must make an affirmative showing of all facts alleged as reasonable cause for such failure in a written statement. The statement must contain a declaration that it is made under penalties of perjury.

In addition, Code §6501(c)(8) provides that the statute of limitations for any tax imposed by the Internal Revenue Code remains open with respect to any event or period to which such information relates until 3 years after the date on which the Form 5471 reporting requirements are satisfied. Under this section, it appears that a tax year could remain open for all issues, not just those relating to Form 5471. Although Treasury has informally stated that this is not the intended result, due regard should be given for the actual language of the statute until the Internal Revenue Service or Treasury issue formal guidance.

Code Section 6035 (Category 1 Filer on Form 5471)

Code §6035 requires each U.S. citizen or resident who is an officer, director, or 10-percent shareholder of a corporation which was a foreign personal holding company ("FPHC") for any taxable year to report certain information pertaining to such corporation. A foreign corporation is an FPHC for a given year if it meets both an income test and a stock ownership test. Code §552(a). The income test is met if at least 60 percent of the foreign corporation's gross income consists of FPHC income (e.g., dividends, interest).⁵ The stock ownership test is met if at any time during the foreign

⁵ Once a corporation is classified as a foreign personal holding company, the threshold for the income test is reduced to 50 percent for subsequent years.

KPMG 0050633

Proprietary Material
 Confidentiality Requested

kpmg Peat Marwick LLP

Page 5
 Robin Paule
 August 20, 2003

corporation's taxable year more than 50 percent of its stock (by voting power or value) is owned directly or indirectly by 5 or fewer U.S. individual citizens or residents. Code §552(a)(2).

For purposes of determining both whether a person is a 10 percent shareholder and whether the ownership test is met, certain constructive ownership rules apply. A person who holds an option to acquire stock is treated as actually owning such stock under Code §§6035(e) and 554(a)(3). Code §554(a)(1) further provides that stock owned directly or indirectly by a corporation, partnership, estate or trust will be considered as owned proportionately by its shareholders, partners or beneficiaries. In addition, Code §554(a)(5) provides that if a person is considered as owning stock by reason of the option attribution rule, such person will be considered as actually owning the stock for purposes of applying certain attribution rules, including attribution from a corporation to its shareholders and from a partnership to its partners.

Application to Facts

Investor owns an option to acquire 50 percent of Exempt Company. Therefore, under the attribution rules, Investor will be treated as owning a 50 percent interest in Exempt Company. Since Investor does not own any additional stock directly, indirectly or constructively, Investor would not be considered as owning *more than 50* percent of Exempt Company. Assuming no other individuals that are U.S. citizens or residents own an interest in Exempt Company, Exempt Company should not be considered an FPHC. Therefore, Investor should not have a Code §6035 reporting requirement with respect to Exempt Company.

We understand that Investor does not own a direct, indirect or constructive interest in Foreign LP (which has elected to be treated as a corporation for U.S. tax purposes). Therefore, based on the conclusion in the OPIS opinion that the swap should not result in the creation of an equity interest, Investor should not have a Code §6035 reporting requirement with respect to Foreign LP.⁶

⁶ As discussed in the OPIS opinion, there is a risk that the total return swap could result in Investor being considered as owning equity in Foreign LP. If this happens, Investor may be considered to own more than 50 percent of Foreign LP and, consequently, would meet the stock ownership test of the FPHC rules. Therefore, assuming the income test is met, Investor (if an individual) or an individual who owns a direct or indirect interest in Investor would be required to file Form 5471 as a "category 1 filer."

kpmg Peat Marwick LLP

Page 6
 Robin Paule
 August 20, 2003

Code Section 6046 (Category 2 and 3 Filer on Form 5471)

The Code includes reporting requirements with respect to organizations or reorganizations of certain foreign corporations and acquisitions and dispositions of certain foreign corporation stock. Code §6046. Code §6046 applies to two separate reporting requirements. First, Code §6046 applies to a U.S. citizen or resident who is an officer or director of a foreign corporation in which a U.S. person owns 10 percent or more in vote or value of the outstanding stock of the foreign corporation. A person meeting these requirements is referred to as a "category 2 filer" on Form 5471.

Second, Code §6046 applies to a U.S. person (U.S. citizen or resident, domestic partnership, domestic corporation, or domestic estate/trust) that meets any of the following conditions: (1) who has acquired stock or additional stock which increases such person's ownership by 10 percent; (2) who owns 10 percent or more in vote or value of the outstanding stock when the foreign corporation is reorganized; (3) who becomes a U.S. person while owning 10 percent or more in vote or value of the outstanding stock of the foreign corporation; or (4) who disposes of sufficient stock to reduce his or her interest to less than 10 percent of the outstanding vote or value of the stock. Reg. §1.6046-1(c). A person meeting these requirements is referred to as a "category 3 filer" on Form 5471. For purposes of determining ownership, Code §6046 provides that ownership includes stock owned directly or indirectly by a person. In addition, an individual is treated as owning stock owned by certain family members. Code §6046(c). Neither the statute nor the corresponding regulations indicate that an option attribution rule applies in determining stock ownership.⁷

Application to Facts

We understand that Investor is neither an officer or director of Exempt Company or Foreign LP. Based on such assumption, Investor should not have reporting requirements under the first scenario and, therefore, would not need to fulfill the category 2 reporting requirements.

Although the matter is not free from doubt, Code §6046 does not appear to impose an option attribution rule for purposes of determining ownership and, therefore, Investor

⁷ Note that for purposes of the Subpart F provisions, Code §958 provides separate definitions for indirect ownership and for constructive ownership. Option attribution applies only under the constructive ownership rules, and not under the indirect ownership rules.

kpmgPeat Marwick LLP

Page 7
 Robin Paule
 August 20, 2003

should not be considered a category 3 filer and should not be subject to the reporting requirements under Code §6046 with respect to Exempt Company. Because Investor does not own an interest in Foreign LP directly, indirectly or constructively, Investor should not have a filing requirement under Code §6046 with respect to Foreign LP.

Code Section 6038 (Category 4 filer on Form 5471)

Code §6038 requires every U.S. person to provide information with respect to a foreign corporation or foreign partnership which such person "controls" for at least 30 days during the annual accounting period of the foreign corporation. For these purposes, a U.S. person is defined as a citizen or resident of the U.S., a domestic partnership, a domestic corporation, or a domestic estate or trust. Code §7701(a)(30).

For corporations, control is defined as ownership of more than 50 percent of the combined voting power or the value of all classes of stock of a foreign corporation. For purposes of determining ownership, the option attribution rule under Code §318 applies. Code §6038(e)(2).

Application to Facts

Investor owns an option to acquire 50 percent of Exempt Company. Therefore, under the attribution rules, Investor will be treated as owning a 50 percent interest in Exempt Company. Since Investor does not own any additional stock directly, indirectly or constructively, Investor would not be considered as owning *more than* 50 percent of Exempt Company. Therefore, Investor would not be considered to control Exempt Company and would not have a reporting requirement under Code §6038.

With respect to Foreign LP (which has elected to be treated as a corporation from its inception for U.S. tax purposes), we understand that Investor does not own a direct or indirect interest. Assuming that, as discussed in the OPIS opinion, the swap does not result in an equity interest, Investor should not be considered to own more than 50 percent of Foreign LP. Consequently, Investor should not have a reporting requirement under Code §6038 with respect to Foreign LP.⁸

⁸ If Foreign LP does not elect corporate treatment from its inception for U.S. tax purposes, Investor potentially could have a Code §6038 reporting requirement. For partnerships, control is defined as ownership of more than 50 percent of the capital interest or 50 percent of the profits interest in such partnership. Code §6038(e)(3). It is possible that the swap would cause Investor to be treated as owning a

kpmg Peat Marwick LLP

Page 8
 Robin Paule
 August 20, 2003

Note that if Investor is an entity or trust, both Investor and any U.S. individual who owns an interest in Investor potentially would be subject to the requirements of Code §6038. However, since neither the individual nor Investor should meet the control definition for purposes of the category 4 filing requirements, neither should have a reporting obligation under Code §6038, as discussed above.

Code Section 964(c) (Category 5 on Form 5471)

Code Section 964(c) and the corresponding regulations require a "U.S. shareholder" of a "controlled foreign corporation" ("CFC") to maintain certain records relating to the CFC's earnings and profits and subpart F income, if any. A foreign corporation is a CFC if more than 50 percent of its stock (by voting power or value) is owned by one or more "U.S. shareholders" at any time during the CFC's taxable year.⁹ Code §957(a). A U.S. shareholder is defined as a U.S. person who owns (directly, indirectly, or constructively) 10 percent or more of the total combined voting power of all classes of voting stock of a CFC. Code §958(a), (b). For purposes of determining ownership, a person who owns an option to acquire stock is treated as actually owning such stock. Code §318(a)(4). Under the CFC rules, only shareholders who own an interest on the last day of the CFC's tax year potentially have an income inclusion. Therefore, "U.S. shareholders" owning stock in a foreign corporation that is a CFC for an uninterrupted period of 30 days or more during any tax year of the foreign corporation, and who owned that stock on the last day of that year must file Form 5471 as a "category 5 filer."

greater than 50 percent profits interest and, consequently, Investor would be required to report certain information on Form 5471.

⁹ The voting power held by U.S. shareholders is determined on a facts and circumstances basis. Reg. §1.957-1(b)(1). U.S. shareholders will be deemed to have more than 50 percent of the voting power of a foreign corporation if they (1) have the power to elect, appoint, or replace a majority of the board of directors, (2) have the power to break a deadlock where U.S. shareholders have the power to elect exactly one-half of the directors, or (3) have the power to elect, appoint, or replace the sole "manager" who exercises the powers ordinarily exercised by a board of directors. Note that a foreign corporation also may be a CFC if its U.S. shareholder possesses practical voting control of the CFC through a formal or informal agreement. *Estate of Weiskopf v. Commissioner*, 58 T.C. 423 (1975), *aff'd per curiam*, 538 F.2d 317 (2d Cir. 1976); *Kraus v. Commissioner*, 59 T.C. 581 (1973), *aff'd*, 490 F.2d 898 (2d Cir. 1974); *Garlock Inc. v. Commissioner*, 58 T.C. 423 (1972), *aff'd*, 489 F.2d 197 (2d Cir. 1973), *cert. denied*, 417 U.S. 911 (1974). Therefore, if Investor has voting control of either Foreign LP or Exempt Company based on facts and circumstances, Investor may have a reporting requirement on Form 5471.

kpmg Peat Marwick LLP

Page 9
 Robin Paule
 August 20, 2003

Application to Facts

As discussed above, even though Investor would be treated as actually owning the stock which it has an option to acquire, Investor should not be considered to own *more than* 50 percent of Exempt Company. Therefore, assuming Investor does not have voting control of Exempt Company through a formal or informal agreement and assuming no other U.S. person owns an interest in Exempt Company (directly, indirectly, or constructively), Exempt Company should not be considered a CFC.

Foreign LP has elected to be treated as a corporation for U.S. tax purposes. Therefore, if Investor (and any other U.S. shareholders) own more than 50 percent of Foreign LP, it would be a CFC. According to the OPIS opinion, however, the swap agreement should not cause Investor to be considered as owning equity in Foreign LP. Assuming this conclusion is correct, no reporting should be required under Code §964(c).¹⁰

Form 8621 Reporting

Based upon our understanding of OPIS, Exempt Company and Foreign LP generally each would be considered a "passive foreign investment company" ("PFIC").¹¹ Since Investor does not own a direct or indirect interest in Foreign LP and owns only an option to acquire stock of Exempt Company, Investor cannot make a qualified electing fund ("QEF") election with respect to either entity. If a QEF election could be made, the reporting requirements discussed below could change.

Generally, any U.S. investor who owns stock in a PFIC, directly or indirectly, must file Form 8621, *Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, with respect to that PFIC interest. Although there are no specific penalties with respect to failing to file Form 8621, general penalties could apply

¹⁰ If the swap instrument results in Investor being treated as owning an equity interest, Investor likely will own more than 50 percent of Foreign LP. If the ownership period includes the last day of Foreign LP's taxable year, Investor likely will be a category S filer.

¹¹ A PFIC is defined as any foreign corporation if: (1) 75 percent or more of its gross income is passive income, or (2) the average percentage of assets (by value) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.

kpmg Peat Marwick LLP

Page 10
Robin Paule
August 20, 2003

(e.g., penalties for underpayment of tax, failure to pay tax, negligence or disregard of rules or regulations).¹²

The Code provides that an option to acquire stock in a PFIC will be treated as actual stock to the extent provided in regulations. Under proposed regulations, a person that holds an option to acquire stock in a PFIC would be considered a shareholder of a PFIC that is a "section 1291 fund" for purposes of applying Code §1291 to a disposition of the option. Prop. Reg. §1.1291-1(d). While these regulations are not yet effective, they would, if enacted in their present form, apply to dispositions which occur on or after April 11, 1992.¹³ If the proposed regulations were adopted in their present form, Investor would be considered a direct owner of Exempt Company's stock (for purposes of applying section 1291 to a disposition).

Under the proposed regulations, Investor would be considered to dispose of PFIC stock if it cash settles the option or allows the option to expire.¹⁴ Prop. Reg. §1.1291-1(d). Accordingly, under the proposed regulations, Investor would be required to file Form 8621 to report such disposition. However, in cases where the option expired worthless, the only items reported on Form 8621 would be a loss on line 10(f) of Part III and a statement explaining the amount and type of stock (options) held and the date of disposition. No income inclusion would be reported on Form 8621. These same reporting requirements also would apply in cases where Investor cash settles the option for less than the price Investor paid for the option. If Investor instead disposed of its option at a gain, Investor would need to complete line 10(f) and line 11 of Part III and likely would have an income inclusion on its U.S. federal income tax return.

Based on the fact that the option attribution rule and the reporting requirements are in proposed regulations, and not in the Code or final regulations, Washington National Tax feels that the Investor should be able to take the position that no reporting is required. Washington National Tax also believes that the policy reasons for the PFIC provisions (anti-deferral of income) are not violated by not filing Form 8621 under these circumstances.

¹² Washington National Tax has confirmed that there are no specific penalties that apply to the failure to file Form 8621, but that other general penalties potentially could apply.

¹³ No assurance can be given whether these regulations will be enacted, or if enacted, whether they will be enacted in their present form (including their effective date).

¹⁴ It should be noted that exercise of the option is not considered a disposition. Prop. Reg. Sec. 1.1291-1(d).

kpmg Peat Marwick LLP

Page 11
Robin Paule
August 20, 2003

♦ ♦ ♦ ♦ ♦

This letter sets forth our views based on the completeness and accuracy of the above-stated facts and any assumptions that were included. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. In rendering our views, we are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and judicial and administrative interpretations thereof, which are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes could also have an effect on the validity of our conclusions.



DRAFT

MEMORANDUM OF TELEPHONE CALL

Client:

Caller : Carl Hastings

Date: May 24, 2000

Received by: Kevin A. Pace

Transcribed by:

Ref: p:\acct\haguer\pace\hastmemo.doc

Kevin, Carl Hastings. Its five minutes after three on Monday, the 22nd, returning your call.

The short answer to your inquiry is, up in the Northeast, at least, there is quite a bit of activity in the trust area where they used to not audit many of these kinds of trusts. They are now auditing quite a number of them because they have figured out that trusts are a common element in some of these shelter deals. So our best intelligence is that you are increasing your odds of being audited, not decreasing your odds by filing that Grantor Trust return. So we have discontinued doing that.

You may want to call either Carol Worley in Dallas or Tracy Henderson in Atlanta. I forget which one of them was tracking the activity up in the Northeast. I think it was Carol, but give her a call. If its not her, she will know who it was and get the most recent intelligence. But again, the short answer is we are not doing that anymore, cause we think it increases the risk instead of decreasing it.

Thanks, Bye.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 327

KPMG 0036353

Unknown

From: Jordan, Robert M
 Sent: Tuesday, February 15, 2000 2:54 PM
 To: Eischeid, Jeffrey A
 Subject: Tax reporting for BLIPS

Jeff,

I don't know if I missed this on a conference call or if there's a memo floating around somewhere, but could we get specific guidance on the reporting of the BLIPS transaction. Maybe its so simple its not necessary, but I just want to be sure. Also I have "IRS matching" concerns. Here are my initial thoughts on reporting:

- 1) Deutsche issues a Substitute 1099 for Dividends (comprised of interest) to the Borrower LLC in that LLC's FEIN
- 2) Strategic Investment Fund issues a K-1 to Borrower LLC in that LLC's FEIN which contains among other things the offsetting interest deduction which presumably comes through as investment interest expense.
- 3) Investor treats Borrower LLC as a disregarded entity and reports activity directly on his tax return.
- 4) Therefore investor reports the following on his 1040:
 - a. Short-Term capital loss on redemption of his partnership interest in Strategic Investment Fund (assuming he elected to be redeemed)
 - b. Dividend income from DB (interest reported as dividends)
 - c. K-1 Activity (including offsetting investment interest expense) from Strategic Investment Fund.
 - d. Investor reports KPMG fee in accordance with prior guidance.

Is this accurate? One concern I have is the IRS trying to match the Deutsche dividend income which contains the Borrower LLC's FEIN (I understand they're not too efficient on matching K-1's but the dividends come through on a 1099 which they do attempt to match). I wouldn't like to draw any scrutiny from the Service whatsoever. If we don't file anything for Borrower LLC we could get a notice which would force us to explain where the dividends ultimately were reported. Not fatal but it is scrutiny nonetheless.

On the other hand, I might have this all wrong. Could you set me straight?

Regards,
 Bob

Robert M. Jordan
 rjordan@kpmg.com
 314.444.1487 (O)
 314.444.1435 (F)
 314.369.4871 (C)
 314.968.8598 (H)
 314.968.8534 (HF)
 KPMG, LLP
 10 South Broadway
 St. Louis MO 63102

Proprietary Material
 Confidentiality Requested

KPMG 0006537

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 328

3814

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=20092
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20092
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: presidio K-1s
Sent: 2000-03-28 03:41:09.716
Date: 2000-03-28 03:41:11.306
X-Folder: BLIPS

It was discussed on the national conference call today. Tracey Stone has been working with Mark Ely on the issue. Ely has indicated that while the IRS may have the capability to match ID numbers for partnerships, they probably lack the resources to do so. While technically the K-1's should have the social security number of the owner on them, it is my understanding that Mark has suggested that we not file a partnership for the single member LLC and that Presidio not file amended K-1's. Mark was of the opinion that it was better to just wait to see if we get a notice from the IRS and then to just respond that it is a single member LLC, not required to file a return, all the income of which has been picked up by the single owner. Tracey indicated that Mark did not like the idea of having us prepare partnership returns this year because then the IRS would be looking for them in future years.

-----Original Message-----

From: Monahan, Jean C
Sent: Monday, March 27, 2000 5:52 PM
To: Eischeid, Jeffrey A; Baumann, Dale R
Cc: Rivkin, David; Heil, Matthew C
Subject: presidio K-1s

We spoke to Steven Buss about the possibility of re-issuing the Presidio K-1s in the EIN of the member of the single member. He said that you guys hashed it out on Friday 3/24 and in a nutshell, Presidio is not going to re-issue K-1s.

David was wondering what the rationale was since the instructions and PPC say that single member LLCs are disregarded entities so 1099s, K-1s should use the EIN of the single member.

Let us know. Thanks.
Jean Monahan
kpmg LLP
Phone: 619-525-3227
Fax: 619-525-3395

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 329

KPMG 0024451

3815

From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=17484
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=17484
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: Nondisclosure
Sent: 2000-03-22 22:25:34.098
Date: 2000-03-22 22:25:38.213
X-Folder: BLIPS

Per our discussion on the conference call on Monday, I called Presidio regarding the California K-1:

I spoke with Steven Buss at Presidio regarding the California K-1. He indicated that they had looked carefully at the filing requirements and the information required in the California source column. He thinks that the current reporting is correct. He indicated that the trading activity took place in California and thus affects the sourcing.

Proprietary Material
Confidentiality Requested

KPMG 0025704

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 329

3816

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=22426
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=22426
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: Grouping BLIPS Investors
Sent: 1999-07-27 21:39:39.201
Date: 1999-07-27 21:39:44.862
X-Folder: BLIPS

Deke

As discussed on the phone, the "blind hog" may have just stumbled upon an acorn, or in this case a nugget. I will follow up on your idea and hopefully it solves our grouping problem.

Randy

-----Original Message-----
From: Carbo, Deke G
Sent: Tuesday, July 27, 1999 2:34 PM
To: Bickham, Randall S; Eischeid, Jeffrey A
Cc: Liston, Shannon L
Subject: Grouping BLIPS Investors

Randy and Jeff:

A thought occurred to me as a way to group investors for BLIPS transactions. Shannon and I have been discussing it and it may be workable depending, as usual, on what the bank is willing to do. It depends on our ability to structure something that fails the definition of a partnership or that qualifies for the election to be excluded from Subchapter K for tax purposes.

The idea is to group several investor contributions in a single DB account rather than separate accounts. The account would be co-owned by investors and may even be styled as ABC Joint Venture Account if it would matter. However, the investors would not form a separate legal entity such as the single-member LLCs we have discussed. The loan would be made to the individuals jointly and the loan proceeds transferred to the DB account. Thus, the co-ownership arrangement, although it may technically be a partnership, would qualify to be excluded from the provisions of subchapter K as long as we met the requirements of Treas. Reg. Section 1.761-2.

Alternatively, it may not even be a partnership required to meet the tests to be excluded under Treas. Reg. Section 1.761-2 since it may fail the definition of a partnership contained in Treas. Reg. Section 301.7701-1(a)(2).

The \$64 question is if the bank has control of the funds at all times, does this solve their security concerns and/or concerns about having loans involving more than one person.

Deke

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 331

KPMG 0023350

Unknown

From: Rivkin, David
 Sent: Monday, April 03, 2000 1:49 PM
 To: Heil, Matthew C; Monahan, Jean C
 Cc: Paule, Robin M
 Subject: FW: Blips and tax filing issues

REDACTED

Please call the cpa for re this. Let's have them error by overestimating income. They can always amend later if they really want to but we should advise against it. Jean please call re this. Robin I assume you have ed under control.

Our advice in this letter is based on the facts as stated and on authorities that are subject to change, retroactively and/or prospectively.

David M. Rivkin
 KPMG
 Partner
 (619) 525-3273 (phone)
 (619) 525-3395 (fax)
 drivkin@kpmg.com

-----Original Message-----

From: Ely, Mark H
 Sent: Monday, April 03, 2000 3:50 AM
 To: Rivkin, David
 Cc: Escheid, Jeffrey A; Heil, Matthew C; Monahan, Jean C; Gallo, Nancy M; Miller Jr., Norlyn D
 Subject: RE: Blips and tax filing issues

Really, the Form 8082 should be filed every time there is an inconsistent position—including when a partner files before the partnership return is filed. If the partner estimates conservatively and in fact, will not amend the return later—i.e. no additional tax due, there are no real consequences in not filing the Form 8082.

Mark H. Ely
 National Partner-in-Charge
 Tax Controversy Technical Services
 Washington National Tax
 KPMG LLP
 p-(202)533-3042; f-(202)533-8546; mhely@kpmg.com

-----Original Message-----

From: Rivkin, David
 Sent: Sunday, April 02, 2000 6:03 PM
 To: Ely, Mark H
 Cc: Escheid, Jeffrey A; Heil, Matthew C; Monahan, Jean C; Rivkin, David
 Subject: FW: Blips and tax filing issues

Mark, if our Blips client estimates K-1 numbers in order to file at 4/15, does the form (I think it is an 8000 series form) need to be filed with his 1040 indicating he is using numbers different than a K-1?

Our advice in this letter is based on the facts as stated and on authorities that are subject to change, retroactively and/or prospectively.

David M. Rivkin
 KPMG
 Partner
 (619) 525-3273 (phone)
 (619) 525-3395 (fax)
 drivkin@kpmg.com

1

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 331

KPMG 0006481

-----Original Message-----

From: Escheid, Jeffrey A
 Sent: Sunday, April 02, 2000 6:00 AM
 To: Rivkin, David
 Subject: RE: Bips and tax filing issues

REDACTED

Maybe, although I'm not sure the form needs to be filed in this situation. When I spoke on Friday with Mark Ely, we simply discussed it as an issue without reaching a conclusion.

-----Original Message-----

From: Rivkin, David
 Sent: Saturday, April 01, 2000 11:55 PM
 To: Escheid, Jeffrey A
 Cc: Heil, Matthew C; Monahan, Jean C
 Subject: RE: Bips and tax filing issues

Jeff, thanks. What also concerns me is that the client in estimating K-1 numbers will probably have to file that form saying they are taking a position different than the K-1. Do you think this raises audit risk? Our advice in this letter is based on the facts as stated and on authorities that are subject to change, retroactively and/or prospectively.

David M. Rivkin
 KPMG
 Partner
 (619) 525-3273 (phone)
 (619) 525-3395 (fax)
 drivkin@kpmg.com

-----Original Message-----

From: Escheid, Jeffrey A
 Sent: Saturday, April 01, 2000 10:28 AM
 To: Rivkin, David
 Subject: RE: Bips and tax filing issues

I believe there is a significant advantage to filing the return now with conservative estimates. It eliminates the possibility that there would be an adverse development that would eliminate the MLTN filing position on the return. The requirements for amended returns are complicated but, essentially, as long as there is a reasonable basis for the return positions at the time of amendment (assuming the taxpayer chooses to amend), he keeps the penalty protection afforded by his previous MLTN opinions.

I'll be around to discuss on Monday if you'd like.

Jeff

-----Original Message-----

From: Rivkin, David
 Sent: Saturday, April 01, 2000 10:12 AM
 To: Watson, Mark T; Escheid, Jeffrey A; Heil, Matthew C
 Cc: Elgin, Evelyn
 Subject: RE: Bips and tax filing issues

The only difference might be the client can always choose not to amend for small changes in estimated K-1 data from entities he controls. Any thoughts?

Our advice in this letter is based on the facts as stated and on authorities that are subject to change, retroactively and/or prospectively.

Unknown

From: Hastings, Carl D
 Sent: Wednesday, June 02, 1999 2:45 PM
 To: Paule, Robin M
 Subject: FW: Single Member LLCs/Community Property States

FYI. Note for our deals. Hopefully we will have clearer guidance soon

CDH

-----Original Message-----

From: Baumann, Dale R
 Sent: Wednesday, June 02, 1999 7:29 AM
 To: Watson, Mark T; Rivkin, David; Hastings, Carl D
 Cc: Bickham, Randall S
 Subject: RE: Single Member LLCs/Community Property States

We have talked about this issue also. One way we may possibly be able to resolve this is to make sure the LLC is funded with separate property. We will need to confirm this with local counsel. We could make sure that happens by having an attorney draft a statement declaring certain property separate property prior to its contribution into the LLC. Otherwise, we will need the individual to borrow the money directly and not through an LLC.

-----Original Message-----

From: Watson, Mark T
 Sent: Wednesday, June 02, 1999 7:18 AM
 To: Rivkin, David; Baumann, Dale R; Hastings, Carl D
 Subject: FW: Single Member LLCs/Community Property States

FYI. This also could be a problem in California.

-----Original Message-----

From: Warley, Carol G
 Sent: Wednesday, June 02, 1999 9:47 AM
 To: Watson, Mark T; Jolly, J. G; Kelliher, William B; Carbo, Deke G
 Subject: FW: Single Member LLCs/Community Property States

Mark, let us know your thoughts. Maybe there is a way to partition?

-----Original Message-----

From: Jolly, J. G
 Sent: Wednesday, June 02, 1999 7:23 AM
 To: Warley, Carol G
 Subject: RE: Single Member LLCs/Community Property States

Carol-

I had several conversations with Bill Kelliher in WNT about this about six months ago. He received informal guidance from Treasury that even if only one spouse was a named member in the LLC, it probably would not be treated as a single member LLC if the interest was community property. You may wish to follow up with Bill on this.

Jerry

-----Original Message-----

From: Warley, Carol G
 Sent: Wednesday, June 02, 1999 1:00 AM
 To: Watson, Mark T
 Cc: Carbo, Deke; Jolly, J. G
 Subject: Single Member LLCs/Community Property States

Deke and I discussed the Blips conference call today and the proposed use of single member LLCs. Deke indicated that he thinks this could be a problem for community property states i.e. husband and wife

would each be members and thus the LLC wouldn't be ignored for federal income tax purposes. Deke indicated that Jerry Jolly previously looked at this issue. There may be an IRS notice or other form of guidance on this. If husband and wife are both members in a community property state, do we then have a problem with getting the right result? Could husband and wife both borrow directly or does the LLC have to borrow?

kpmg

Carol Warley
PFP
713-319-2180 phone
713-319-2040 fax
cwarley@kpmg.com e mail

David M. Rivkin
KPMG
Partner
(619) 525-3273 (phone)
(619) 525-3395 (fax)
drivkin@kpmg.com

-----Original Message-----

From: Watson, Mark T
Sent: Thursday, March 30, 2000 4:32 PM
To: Rivkin, David; Eischeid, Jeffrey A; Heil, Matthew C
Cc: Elgin, Evelyn
Subject: RE: Blips and tax filing issues

REDACTED

David, it seems to me that in either event -- i.e., amending the return or extending the return -- you are going to have to abide by the law at the time the amended/extended return is filed. Thus, I don't see a significant difference between the alternatives.

-----Original Message-----

From: Rivkin, David
Sent: Sunday, March 26, 2000 9:27 PM
To: Watson, Mark T; Eischeid, Jeffrey A; Heil, Matthew C
Cc: Elgin, Evelyn
Subject: RE: Blips and tax filing issues

I was not worried about extensions causing scrutiny, but rather a risk that something might happen whereby the client cannot rely on our opinion letter. This is the risk I am weighing.

Our advice in this letter is based on the facts as stated and on authorities that are subject to change, retroactively and/or prospectively.

David M. Rivkin
KPMG
Partner
(619) 525-3273 (phone)
(619) 525-3395 (fax)
drivkin@kpmg.com

-----Original Message-----

From: Watson, Mark T
Sent: Thursday, March 23, 2000 11:57 AM
To: Eischeid, Jeffrey A; Heil, Matthew C
Cc: Rivkin, David; Elgin, Evelyn
Subject: RE: Blips and tax filing issues

Perhaps Eve thinks differently, but my inclination is that amending a return will generate more scrutiny than extending a return.

-----Original Message-----

From: Eischeid, Jeffrey A
Sent: Thursday, March 23, 2000 8:49 AM
To: Heil, Matthew C; Watson, Mark T
Cc: Rivkin, David; Elgin, Evelyn
Subject: RE: Blips and tax filing issues

You might want to discuss this issue with Eve. We asked her to begin thinking about this earlier this year. I don't believe we ever came to a conclusion.

Jeff

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 331

KPMG 0006480

kpmg Peat Marwick LLP

To KPMG Working Group

Date March 6, 1998

From Bob Simon / Margaret Lukes

Steno ft

Ref c:\windows\temp\me0250.doc

Potential FLIP Reporting Strategy

As discussed in our memo on Form 5471 reporting dated February 2, 1998, the foreign corporation in the global foreign leveraged investment ("FLIP") strategy would be considered a specified corporation under IRC §898 and, therefore, generally would need to conform its year end to that of its majority U.S. shareholder (i.e., the calendar year). We mentioned in a footnote that although the foreign corporation could elect a year end that is one month earlier than the majority U.S. shareholder's year end, this would not likely affect the reporting requirements. However, there is a potential strategy which, while not avoiding reporting, may defer the filing of Form 5471 until the U.S. Investor's tax year following the tax year in which the FLIP transactions take place.

Under Proposed Regulation §1.898-1(c), a specified foreign corporation is not required to conform its tax year to its majority shareholder's tax year so long as its U.S. shareholders do not have any amount includible in gross income pursuant to the subpart F provisions and do not receive any actual or deemed distributions attributable to amounts described in the foreign personal holding company provisions. As discussed in the FLIP opinion, the U.S. Investor (including a partnership or trust in which the U.S. Investor is a partner or beneficiary) should not have an income inclusion under either the subpart F provisions or the foreign personal holding company provisions. Therefore, while the general rule of IRC §898 (which would typically require a calendar year) has the force of law, a position may be taken (under the proposed regulations) that the foreign corporation in the FLIP strategy should be able to elect a fiscal year end.

In our prior memo, we determined that a U.S. Investor would have a reporting requirement under both IRC §6035 and IRC §6038. These reporting requirements would still apply even if the foreign corporation has a different year end. However, the timing of the filing of Form 5471 may change.

Information required to be reported under IRC §6035 and IRC §6038 must be reported on Form 5471 for the tax year of the foreign corporation that ends with or within the reporting person's tax year. Regulation §1.6035-1(b); Regulation §1.6038-2(a). Therefore, if the foreign corporation is a newly established entity that elects a fiscal year end, it will not have a year end that ends with or within the reporting person's tax year for the year in which such foreign corporation is established.

Therefore, assuming the foreign corporation in the FLIP strategy has a June 30 year end (and is established after June 30, 1997), U.S. Investor has a December 31 year end, and

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 332

KPMG 0050644

kpmg Peat Marwick LLP

Page 2
KPMG Working Group
August 20, 2003

the FLIP transactions occur between June 30 and December 31, 1997 the following reporting requirements would apply:

With respect to U.S. Investor's 1997 tax year:

- Investor files U.S. return - FLIP transactions reflected on the return.
- No Form 5471 is required under either IRC §6038 or IRC §6035 because foreign corporation would not have a tax year ending with or within U.S. Investor's tax year. Reporting on Form 5471 would be deferred until U.S. Investor's 1998 tax year.

With respect to U.S. Investor's 1998 tax year:

- Investor files U.S. return - no FLIP transactions reflected on the return.
- Investor files Form 5471 for foreign corporation's year ending June 30, 1998 - certain tax effects of FLIP transactions shown. If U.S. Investor holds its interest through a U.S. partnership, the partnership can file Form 5471 and the U.S. Investor can merely attach a statement to its return identifying the partnership as the reporting entity.

Author: Gregg W. Ritchie at KPMG WARNER_CENTER
 Date: 3/11/98 12:18 PM
 Priority: Urgent

TO: Dale A. Affonso at KPMG Las Vegas
 TO: Harvey L. Armstrong at KPMG Silicon Valley
 TO: Richard J. Bloom at KPMG Short Hills
 TO: Carolyn B. Branan at KPMG Charlotte
 TO: David Cohen at KPMG Chicago
 TO: Edmund N. Desany at KPMG Burlington
 TO: Jeffrey A. Eischeid at KPMG Atlanta2
 TO: Laurence Foster at KPMG WFO Tax
 TO: Randall A. Hamilton at KPMG Des Moines
 TO: R. J. Heath at KPMG W Virginia
 TO: Mark C. Hutchison
 TO: Dennis A. Ito at KPMG SAN FRANCISCO3
 TO: Michael Magee at KPMG Short Hills
 TO: George N. McCrimlik at KPMG LOS ANGELES2
 TO: John W. Monaco at KPMG Norfolk
 TO: Katherine A. Pace at KPMG Orlando
 TO: Robin M. Paule
 TO: Gary M. Powell at KPMG Denver3
 TO: Steven Probas at KPMG WFO Tax
 TO: Eugene G. Schorr at KPMG WFO Tax
 TO: Neil J. Tandler at KPMG Short Hills
 TO: B. Michael Watkins at KPMG Philadelphia
 TO: Howard J. Weiner at KPMG COUNTRYROSE2
 Subject: Potential FLIP Reporting Strategy

----- Message Contents -----

The attached memorandum offers you an alternative filing strategy relative to the Form 5471 which is required to be attached to those individuals' income tax returns who participated in the FLIP strategy.

If you need further clarification, please contact Margaret Lukes (Denver) or Robin Paule (Warner Center).

----- Forward Header -----

Subject: Potential FLIP Reporting Strategy
 Author: Margaret M Lukes at KPMG Denver3
 Date: 3/6/98 10:33 AM

Gregg,

The attached memo describes a potential reporting strategy for the FLIP transaction. If you feel it has merit, please feel free to distribute it among the appropriate engagement partners.

Margaret

Proprietary Material
 Confidentiality Requested

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 332

KPMG 0034372

KPMG Peat Marwick LLP

To KPMG Working Group

Date March 6,

From Bob Simon / Margaret Lukes

Sam R
Ref p/used/used

cc Potential FLIP Reporting Strategy

Proprietary Material
Confidentiality Requested

KPMG 0034373

As discussed in our memo on Form 5471 reporting dated February 2, 1998, the foreign corporation in the global foreign leveraged investment ("FLIP") strategy would be considered a specified corporation under IRC §898 and, therefore, generally would need to conform its year end to that of its majority U.S. shareholder (i.e., the calendar year). We mentioned in a footnote that although the foreign corporation could elect a year end that is one month earlier than the majority U.S. shareholder's year end, this would not likely affect the reporting requirements. However, there is a potential strategy which, while not avoiding reporting, may defer the filing of Form 5471 until the U.S. investor's tax year following the tax year in which the FLIP transactions take place.

Under Proposed Regulation §1.898-1(c), a specified foreign corporation is not required to conform its tax year to its majority shareholder's tax year so long as its U.S. shareholders do not have any amount includible in gross income pursuant to the subpart F provisions and do not receive any actual or deemed distributions attributable to amounts described in the foreign personal holding company provisions. As discussed in the FLIP opinion, the U.S. investor (including a partnership or trust in which the U.S. investor is a partner or beneficiary) should not have an income inclusion under either the subpart F provisions or the foreign personal holding company provisions. Therefore, while the general rule of IRC §898 (which would typically require a calendar year) has the force of law, a position may be taken (under the proposed regulations) that the foreign corporation in the FLIP strategy should be able to elect a fiscal year end.

In our prior memo, we determined that a U.S. investor would have a reporting requirement under both IRC §6035 and IRC §6038. These reporting requirements would still apply even if the foreign corporation has a different year end. However, the timing of the filing of Form 5471 may change.

Information required to be reported under IRC §6035 and IRC §6038 must be reported on Form 5471 for the tax year of the foreign corporation that ends with or within the reporting person's tax year. Regulation §1.6035-1(b); Regulation §1.6038-2(a).

Therefore, if the foreign corporation is a newly established entity that elects a fiscal year end, it will not have a year end that ends with or within the reporting person's tax year for the year in which such foreign corporation is established.

Therefore, assuming the foreign corporation in the FLIP strategy has a June 30 year end (and is established after June 30, 1997), U.S. investor has a December 31 year end, and the FLIP transactions occur between June 30 and December 31, 1997 the following reporting requirements would apply:

With respect to U.S. investor's 1997 tax year:

Investor files U.S. return - FLIP transactions reflected on the return.
No Form 5471 is required under either IRC §6038 or IRC §6035 because foreign

corporation would not have a tax year ending with or within U.S. Investor's tax year. Reporting on Form 5471 would be deferred until U.S. Investor's 1998 tax year.

With respect to U.S. Investor's 1998 tax year:

Investor files U.S. return - no FLIP transactions reflected on the return.
Investor files Form 5471 for foreign corporation's year ending June 30, 1998 - certain tax effects of FLIP transactions shown. If U.S. Investor holds its interest through a U.S. partnership, the partnership can file Form 5471 and the U.S. Investor can merely attach a statement to its return identifying the partnership as the reporting entity.

Proprietary Material
Confidentiality Requested

KPMG 0034375

kpmg Peat Marwick LLP

Personal Financial Planning

To SPV File

Date March 31, 1998

From Robin Paule
Los Angeles/Warner Center

Sleno rp
Ref c:\windows\temp\me0a00.doc

Form 5471 Filing Issues

Since the U.S. Investor will have no includible Subpart F income or Foreign Personal Holding Company Income, the foreign corporation may have a tax year other than that of its majority U.S. Shareholder under Proposed Reg. Sect. 1.898-1(c). See Margaret's memo dated March 6, 1998.

I have contacted Norm Bontje at Quadra and he has indicated that they can change the year end of the foreign corporation, should we prefer a year end other than December 31. Information required to be reported under IRC Sects. 6035 and 6038 must be reported on Form 5471 for the tax year of the foreign corporation that ends with or within the reporting person's tax year. For example, any activity occurring in the foreign corporation from 3/1/97-2/28/98 will be reported on a Form 5471 filed with the U.S. taxpayer's 1998 tax return.

As previously discussed in Margaret's memo dated February 3/5, 1998, the U.S. Investor involved in the FLIP strategy will have reporting requirements on Form 5471 as a category 1, 4 & 5 filer.

Per conference call with Margaret Lukes, Allison Hess and Randy Bickham, we determined that the following filings are required for the FLIP transaction:

LLC, Partnership or S Corporation

Where the U.S. Investor holds the interest in the Cayman corporation through a U.S. LLC, Partnership or S corporation, the LLC, Partnership or S corporation must file a Form 5471 as a category 4 & 5 filer. This includes the completion of Schedules A, B, C, E, F, H, I, J, and M.

LLC Members, Partners or S Corporations

As neither an LLC, partnership nor an S corporation are considered individuals with a category 1 filing requirement, and assuming the Cayman corporation is a FPHC, U.S. Investors who are individuals must file schedules A, B and N of Form 5471 to comply with the category 1 filing requirement.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 332

KPMG 0011952

KPMG Peat Marwick LLP

Page 2
SPV File
February 6, 2002

As for satisfying the category 4 and 5 filing requirements, provided the LLC, partnership or S corporation files the required schedules on the U.S. individual's behalf, the U.S. individual need not complete those same schedules. The individual must, however, attach a statement to their return indicating that the liability for filing the requisite schedules has been satisfied by another U.S. person and identifying the return with which the information was or will be filed and the place of filing.

If the LLC member or partner is a *non-grantor trust*, since a trust is not considered an individual, it does not have a category 1 filing requirement. Therefore, its filing requirements can be satisfied by attaching a statement to the returns that the liability for filing the requisite schedules as a category 4 & 5 filer have been satisfied by another U.S. person filing on their behalf (see above).

If there are individual beneficiaries who have actuarial interests in the non-grantor trust, they may be subject to file as a category 1 filer. However, this filing requirement can be satisfied if a related individual (as defined in Section 318) files on their behalf. The beneficiaries must attach a statement indicating that the related U.S. individual filed on their behalf (see above).

From: </O=KPMG/OU=US/CN=RECIPIENTS/CN=20092>
To: </O=KPMG/OU=US/CN=RECIPIENTS/CN=20499>
Sent: Monday, January 03, 2000 12:00 AM
Subject: 988 election memo

Jeff,

You may want to remind everyone on Monday that they should NOT put a copy of Angie's email on the 988 elections in their BLIPS file. It is a roadmap for the taxing authorities to all the other listed transactions. I continue to find faxes from Quadra in the files that were put together at the time of the transaction in the two 1996 deals here which are under CA audit which reference multiple transactions - not good if we would have to turn them over to California.

Dale Baumann
kpmg Silicon Valley Office - Mountain View

* (650) 404-5307
* (650) 960-0952
* dbaumann@kpmg.com

Our advice in this email message is limited to the conclusions specifically set forth herein and is based on the completeness and accuracy of the stated facts, assumptions and/or representations included. In rendering our advice, we may consider tax authorities that are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our advice. We will not update our advice for subsequent changes or modifications to the law and regulations, or to the judicial and administrative interpretations thereof.

Proprietary Material
Confidentiality Requested

KPMG 0026345

Permanent Subcommittee on Investigations EXHIBIT #155 - FN 341
--

5/6/2003

3831

From /O=KPMG/OU=US/CN=RECIPIENTS/CN=17992
From: /O=KPMG/OU=US/CN=RECIPIENTS/CN=17992
To: /O=KPMG/OU=US/CN=RECIPIENTS/CN=20499
Subject: OPIS Workpaper Files
Sent: 1998-09-16 20:34:05.937
Date: 1998-09-16 20:38:38.040
X-Folder: Documentation

After all the back and forth of presenting the idea to the client and implementing, I find I have quite a few documents/papers/notes related to the OPIS transaction. Rather than just file them away, it occurs to me that we should adopt some standard guidelines regarding the minimum and MAXIMUM amount of information to retain. Purging unnecessary information now pursuant to an established standard is probably OK. If the Service asks for information down the road (and we have it) we'll have to give it to them I suspect. Input from (gulp) DPP may be appropriate here.

Regards,
Bob

Proprietary Material
Confidentiality Requested

KPMG 0025729

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 342

Unknown

From: Rosenthal, Richard P
 Sent: Monday, March 04, 2002 10:24 AM
 To: Brasher, James J (US/Chicago AMP); Duer, Walter M; McCahill, Robert T; Colley, Peter M; Katz-pearlman, Sharon D; Wiseberg, Stanley C; Smith, Richard H (US/WEST AMP); Chopack, John J; Crawford, Thomas W; Hibbitt, William J; Reilly, William A
 Cc: Jones, Ken-WASH-DC
 Subject: RE: TCS Review of TEMPEST and OTHELLO

I will send the project management memo out by tomorrow. As to the existing issues, I agree, it would be helpful to review these client by client. Regardless of who has full authority, we did agree to stick to the budgets and not exceed them until all parties agreed.

Rick

-----Original Message-----

From: Brasher, James J (US/Chicago AMP)
 Sent: Monday, March 04, 2002 9:08 AM
 To: Duer, Walter M; McCahill, Robert T; Colley, Peter M; Rosenthal, Richard P; Katz-pearlman, Sharon D; Wiseberg, Stanley C; Smith, Richard H (US/WEST AMP); Chopack, John J; Crawford, Thomas W; Hibbitt, William J; Reilly, William A
 Cc: Jones, Ken-WASH-DC
 Subject: RE: TCS Review of TEMPEST and OTHELLO

Walter, rather than deal with this issue in the abstract, it would probably be helpful to discuss the specific projects involved. If there are people that are not following the rules then we should deal with it on a case by case basis. Please let me know if there are any MW engagements that we need to discuss. Also, your quotation of the rule below re who has full authority for these engagements seems to be directly in contrast with what Rick layed out at the last leadership meeting. At that time, I thought that he said that the AMP's, in cooperation with the various service line leaders, were going to be responsible for making sure that there is a budget and an agreed revenue allocation at the beginning of every big multi disciplinary engagement. Rick, would it be helpful to clarify the policy?

Regards Jim

Our advice is based on the facts as stated and on authorities that are subject to change, retroactively or prospectively.

-----Original Message-----

From: Duer, Walter M
 Sent: Friday, March 01, 2002 10:12 AM
 To: McCahill, Robert T; Colley, Peter M; Rosenthal, Richard P; Katz-pearlman, Sharon D; Wiseberg, Stanley C; Brasher, James J (US/Chicago AMP); Smith, Richard H (US/WEST AMP); Chopack, John J; Crawford, Thomas W; Hibbitt, William J; Reilly, William A
 Cc: Jones, Ken-WASH-DC
 Subject: RE: TCS Review of TEMPEST and OTHELLO

I have gotten VMs from Reilly, McCahill, and Katz-Pearlman, that the TCS review of TEMPEST and OTHELLO, and even some of the M&A involvement are incurring charges far beyond the budgets. One of the messages said that TCS charges in one contract are over \$200,000 and some charges are really for future work. Another stated that M&A budgets of \$100,000 were being exceeded. These actions are leaving dramatically less premiums and driving havoc with Stratecon's budgeting process. During January there was a conference call between Reilly

Proprietary Material
 Confidentiality Requested

5/7/2003

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 342

KPMG 0032378

and Rosenthal and others that approved the rule that Stratecon partners have full responsibility for these engagements including all budgets - not TSPs and not AMPs.

Those departments which exceeded their budgets with approval would incur an ERP hit. The budgets would include who and where the TCS reviews would be done. The agreement as set forth in Bob's memo was that the TCS reviews would be budgeted centralized in the Northeast. I was of the impression, that this agreed upon process/ground rules would be followed. Yesterday's VMs made it clear they are being ignored and are a renewed cause of great frustration with many partners. In addition, it appears cash is being collected by TSPs and held in their contracts without allocations to Stratecon contracts.

Let me reiterate the rules:

1. Stratecon partners are ultimately responsible for the engagement and set the budgets with input of course from the TSPs and other team members
2. The TCS review will be conducted out of the Northeast
3. Those departments that exceed their budgets must take an ERP hit unless otherwise approved by the Stratecon partner

I am having our CFO, Hunter Lyle review these contracts. Where violations occurred, adjustments will be made.
MESSAGE FROM BOB MCCAHERILL ON REASONS WHY TCS REVIEW SHOULD BE IN THE NORTHEAST. THIS HAS BEEN APPROVED BY KEN JONES.

Walter,

As we discussed today the following is a draft that hopefully you and Ken can modify as necessary and then send to the area AMPs and perhaps Stratecon and IRS Controversy Leaders within KPMG's respective regions including WNT:

There is current IRS audit activity with respect to two early TEMPEST engagements. One situation is under fairly intense scrutiny by IRS Financial Institutions and Products specialists and because it involves a capital loss carry-back is subject to Joint Committee Review. Another Big 5 firm is handling the audit, however KPMG is providing assistance to the other firm.

Although KPMG has yet to receive a subpoena or any other request for documents, client lists, etc. we believe it is likely that such a request(s) is inevitable. Since TEMPEST is a National Stratecon solution for which Bob McCahill and Bill Reilly were the Co-Champions and involved in some fashion in every closed transaction, it is most efficient to have all file reviews and "clean-ups" (electronic or hard copy) performed in one location, namely the FS NYC office. This effort will be performed by selected NE Stratecon professionals that work with Bob and Bill with oversight and consultation being provided by Sharon Katz-Pearlman's group (which is also housed in this office) with ultimate review and final decision making by Ken Jones.

Although OTHELLO (a somewhat similar National Stratecon solution also developed by the NY based FS Stratecon group led by Bob McCahill and Bill Reilly) transactions have just been completed and not yet reflected on any taxpayer's

Proprietary Material
Confidentiality Requested

5/7/2003

KPMG 0032379

return interaction with other Big 5 firms as auditors as well as recent regulations issued by the IRS suggest that there could be a risk of IRS scrutiny even before tax returns reflecting these transactions are filed. Thus, we want the same approach to be followed for OTHELLO as outlined above for TEMPEST.

Senior tax leadership, Jeff Stein and Rick Rosenthal concur with this approach.

Please make sure you and the other professionals in your group cooperate with any requests (including sending files, electronic or otherwise) that the individuals managing this firm risk management project may require.

Thanks for your cooperation.

Walter and Ken

3835

kpmgPeat Marwick LLP

PPF

To Distribution List
From Gregg W. Ritchie
Capital Transaction Strategies
cc See list

Date July 14, 1998
Steno jcZ
Ref p:\users\lsbutler\wp\pzyisk\pr
ontfeelcontfee.doc

Rule 302 and Contingency Fees - CONFIDENTIAL

Background

Rule 302 - Contingency Fees - of the Code of Professional Conduct states:

A member in public practice shall not

(1) Perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the member or the member's firm performs

(a) an audit or review of a financial statement; or

(b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or

(c) an examination of prospective financial information; or

(2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

The prohibition in (1) above applies during the period in which the member or the member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

Except as stated in the next sentence, *a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.* Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. Emphasis added.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 355

KPMG 0026555

A member's fees may vary depending, for example, on the complexity of services rendered.

Application to Tax Practice's Business Plan

The tax practice has embraced a strategy of going to market with leading edge, innovative tax planning strategies. The strategies that have been produced to date, and which we expect to produce as we go forward, require significant resources to develop and an attendant significant investment by the tax practice. Accordingly, a decision was made to price these solutions based upon the predicted results a client can expect from implementing a particular strategy. The pricing strategy is designed as a win-win solution, where our clients benefit from our commitment to bringing them cutting edge solutions in a timely manner and KPMG benefits from the investment necessary to bring our clients these solutions. Unfortunately, it appears that our pricing strategy and, perhaps, the entire tax practice's business plan, is at risk.

The following is a brief description of a key issue facing our ability to successfully implement the tax practice's vision, concluding with a short list of issues that must be resolved. The issues revolve around Rule 302 of Rule the Code of Professional Conduct.

Current Application of Rule 302 to the CaTS Practice

There are several CaTS products that are priced on a value-added basis. Recently, the practice has been told by DPP-Tax (who consulted with DPP-Assurance on the matter) that as structured the fees related to the OPIS product must be viewed as contingent fees under Rule 302. Initially, the practice did not view this as a problem since our target market is individual clients (not assurance clients). However, DPP has also indicated that the CaTS practice may not charge a contingent fee to an individual who "exerts significant influence over an assurance client." This, unfortunately, will have a significant impact on our CaTS practice as many, if not most, of our CaTS targets are officers/directors/shareholders of our assurance clients.

Specifically with respect to the OPIS transaction, it is still far from clear that DPP's interpretation of Rule 302 as it applies to the OPIS fee arrangement is correct in its conclusion that the fee structure is a contingent fee. The rationale enunciated by DPP for finding that the OPIS product involves a contingent fee seems to be as follows:

- A fee is paid to KPMG by a third party, Presidio Investment Advisors (Presidio), on behalf of the client. KPMG and the client execute a formal engagement letter in which the client indicates their acknowledgment that a fee will be paid on their behalf by Presidio to KPMG for KPMG's tax services (*i.e.*, rendering of tax advice with respect to the proposed transaction and drafting of an opinion letter with respect to the tax ramifications of the transaction once completed) rendered to the client.
- As presently structured, a fee is only payable to us if the client executes the strategy. As discussed, our formal engagement letter with the client indicates that a fee will be paid to KPMG by Presidio on the client's behalf for tax advice and an opinion letter. However, such advice and an opinion letter would not be required if the strategy is not executed.

- Our fee is calculated as a percentage of the client's investment. The fee structure is embedded in our engagement letter with Presidio and is denominated as a graduated percentage of the amount of the client's investment (ranging from 1 to 1.35 percent). While there is some correlation between the size of a client's investment and the client's ultimate tax result, our engagement letter with Presidio does not require that our fee be adjusted to account for a client's actual tax result. Indeed, we are entitled to payment from Presidio prior to the time at which the client's ultimate tax result is known.

The CaTS practice has other products that involve the receipt of value added fees. Some of these products (e.g., the PAT, the 501(c)(15) family insurance company, etc.) also involve a fee which is determined based on the projected amount of the gain that would otherwise be taxed to the individual. However, the amount of the fee is, as stated, based on the **projected** amount of the gain that would otherwise be taxable. In none of these engagements is the fee adjusted for or dependent on the actual amount of tax savings actually achieved by a client.

Projected fee loss with respect to OPIS alone if DPP's interpretation of Rule 302 is correct: \$10 - \$15 million.

Application to TTM/STM

Until recently, it was KPMG's position that a STM or TTM initial client visit (ICV) letter (essentially, an engagement letter to perform a feasibility analysis) could state that should a client decide to proceed with implementation after the completion of the feasibility phase, the fixed fee for implementation would be equal to *a percentage of an agreed upon projected tax savings*. The implementation phase engagement letter included a fixed dollar fee that was calculated, as specified in the ICV letter, based upon a percentage of a mutually agreed upon projected tax savings. This fixed fee approach was deemed acceptable for engagements with both assurance and non-assurance clients, and was adopted for new tax solutions developed as part of the tax practice's business plan to drive growth through pursuing value added engagements with both assurance and non-assurance clients.

Recently, DPP has insisted that both STM and TTM remove language from their ICV letters which stated that the fixed fee for implementation would be based upon a percentage of an agreed upon projected tax savings. In addition, where similar language had been initially inserted in draft engagement letters for a number of recently introduced tax solutions, DPP required its removal. The reason stated for requiring the change to TTM and STM ICV letters and for excluding such language from other new products' engagements letters was that this arrangement amounts to a contingent fee arrangement under DPP's interpretation of Rule 302. This appears to be a change of position for DPP given that no changes have been made to the wording of Rule 302 since their initial contrary determination.

Estimate of fee recently lost on one TTM engagement as a result of the language now used in TTM ICV letters as required by DPP: \$10 - \$15 million.

Application to Tax Practice's Product Development Initiative

Acquisition Cost Recovery Analysis (ACRA), the first product to emerge from the Tax Innovation Center (TIC) as a product fully developed within the TIC, was initially to be introduced to the tax practice in a Tax Product Alert (TPA) that described ACRA's pricing as a percentage of projected tax savings - the standard language that was in use in TAM ICV letters at that time. DPP insisted the language be removed. Similarly, when the TTM practice was re-introduced to the tax practice as a whole through a TPA DPP insisted that language describing the fee for a TTM engagement as based upon a percentage of projected tax savings, which was an accurate description of the language contained in the TTM ICV letter in use at the time the TPA was to be released and that was language previously approved by DPP for the ICV letter, the TIC was required to remove the language. The concern raised by DPP in requiring the removal of the language was that the pricing arrangement described was an impermissible contingent fee. Since then, the TIC has not attempted to use this language in a TPA to describe how a product is priced.

The TIC is concerned that DPP's interpretation of Rule 302 is overly broad because it threatens the value to KPMG of a number of product development efforts that are currently in the pipeline. For example, the 357(c) product will be a prime candidate for implementation by assurance clients. However, DPP's interpretation of Rule 302 hampers our ability to price the solution on a value added basis. In addition, the Leveraged COLI Solution currently under development, which has the potential to generate in excess of \$25 million in fees if delivered on a value added basis, may generate less than \$5 million if the suggested fee structure is interpreted by DPP as a contingent fee by application of Rule 302. Finally, it is anticipated that many future tax solutions developed in the TIC will encounter the same pricing issue.

Summary

While the CaTS practice, the TTM practice, the STM practice, and the TIC all agree that KPMG should not engage in behavior not fully in compliance with and that does not follow the Code of Professional Conduct, they also believe it is essential that if the tax practice is to realize the ambitious revenue goals set forth by our leadership we are certain that an overly broad interpretation of Rule 302 has not been adopted by the firm. While adoption of an overly broad definition of Rule 302 might be preferable from a risk management perspective, it is important that such an interpretation be not be adopted with only a risk management objective in mind unless an affirmative decision by the firm's leadership has been made that this is appropriate.

At the present time, we do not know if DPP's interpretation of Rule 302 has been adopted with the full awareness of the firm's leadership as a result of risk management concerns. However, it is our impression that no one other than DPP has fully considered the issue and its impact on the tax practice, and our reading of Rule 302 leaves us with the impression that the interpretation of Rule 302 presently applied to tax products appears broader than strictly required by the rule. Our ultimate concern is that an impartial party has yet to weigh both the important risk management objectives and the equally important tax business plan objectives to help ensure that the firm adopts a fee policy that is not based upon an overly broad interpretation of Rule 302.

So that our concerns may be addressed, we believe the following questions must be answered by DPP so that a business decision can be made regarding how broad the firm's interpretation of Rule 302 must be in order to comfortably address the firm's risk management concerns with respect to the contingency fee issue, keeping in the proper perspective the tax practice's business plan.

- 1) Is a fixed fee that is calculated as a percentage of a mutually agreed upon projected tax savings for services rendered with respect to a prospective tax planning strategy a contingent fee as defined by Rule 302?
- 2) Does the fact that with the formal understanding of the client KPMG's fee is paid through a third party intermediary as memorialized in an engagement letter with the client affect the contingent fee analysis?

Distribution List:
 Walter Duer, Houston
 Ron Harvey, NYO
 Steve Rainey, WNT
 Gregg Ritchie, Warner Center
 Mark Springer, WNT TIC

cc:
 Jeff Eischeid, Atlanta

**Proprietary Material
 Confidentiality Requested**

KPMG 0026559

Unknown

From: Etscheid, Jeffrey A
 Sent: Wednesday, July 21, 1999 8:10 AM
 To: Comer, Michael S
 Cc: Ammerman, Douglas K; Green, Douglas J
 Subject: FW: National Accounts Database

The following is a draft "product pitch" similar to the one you forwarded me last month. Note that this product has received tentative DPP-Tax approval. It is still subject to Washington National Tax review of the underlying documentation to insure the documentation comports with various representations. That review is currently in process and should be completed some time this week or next week. To be conservative, you should probably wait for formal approval before distributing your email to National Account TSPs.

I'd like to talk to you about more specific targeting within the National Accounts list. This effort is going to be somewhat difficult given the breadth of application of the BLIPS product.

Finally, I am not sure how to integrate the BLIPS product announcement with the broader PFP issue we discussed on the 14th. Specifically, if the priority of the TSPs is to enhance KPMG's relationships with the "C class", they should introduce their local PFP partner and the broad services that the PFP practice offers, e.g., tax return preparation, estate planning, stock option planning, retirement planning, etc. Innovative Strategies (formerly CaTS) is an integral part of that broad practice and is something like the icing on the cake. If the notion of a broad PFP relationship doesn't sell in a particular situation, we can at least offer key executives an introduction to Innovative Strategies. Innovative Strategies is a portfolio of value-added products that are designed to mitigate an individual's income tax as well as estate and gift tax burdens. BLIPS is just one of the products in the Innovative Strategies portfolio.

Jeff

***** ACTION REQUIRED *****

PRODUCT: BLIPS

CRITERIA: Individuals with:

- significant (> \$20 million) capital gain income, e.g., sale of company stock, or
- significant (> \$20 million) ordinary income, e.g., exercise of nonqualified options.

VALUE PROPOSITION: Reduces Federal and state tax liabilities by making tax advantaged investments in emerging markets currencies. Aside from trading profits, a key objective is for the tax loss associated with the investment structure to offset/shelter the taxpayer's other, unrelated, economic profits. This is a turnkey investment program that integrates the services of various parties including the investment advisor, legal/drafting, banking, and KPMG tax opinion. The all-in cost of the program, assuming a complete loss of investment principal, is 7% of the targeted tax loss (pre-tax). The tax benefit of the investment program, which ranges from 20% to 45% of the targeted tax loss, will depend on the taxpayer's effective tax rates.

FEE: BLIPS is priced on a fixed fee basis which should approximate 1.25% of the tax loss. Note that this fee is included in the 7% described above.

CONTACT:

Jeff Etscheid - Personal Financial Planning - Atlanta-404/222-3180

1

Proprietary Material
 Confidentiality Requested

KPMG 0040502

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 359

3841

-----Original Message-----
From: Conner, Michael S
Sent: Tuesday, July 20, 1999 10:12 AM
To: Elschold, Jeffrey A
Subject: National Accounts Database

<< File: NA720.xls >>
Jeff,

Attached is the current listing of National Accounts for the PFP analysis. It's not substantially different than the June 2 listing. Let me know if you need any other information.

Michael
212 872 6038

2

Proprietary Material
Confidentiality Requested

KPMG 0040503

Tax Solution Alert

April 24, 2000 (originally issued)
 December 7, 2001 (latest revision)
 FY00-28

Internal Use Only - Not for Distribution or Circulation Outside the Firm

S-Corporation Charitable Contribution Strategy

Digest

S-Corporation Charitable Contribution Strategy is designed to enable shareholders of S-corporations to make charitable contributions in a tax-efficient manner, without the immediate outlay of cash, and enhance S-corporation cash flow for business growth and expansion. S-Corporation Charitable Contribution Strategy is structured as a fixed-fee engagement. Because of the complexity of this strategy, it must be implemented only with the assistance and supervision of the National Deployment Team. The team is comprised of professionals from the federal tax and Personal Financial Planning practices; the members are listed in this *Tax Solution Alert*.

This *Tax Solution Alert* and any toolkit items that are generally available to all tax professionals can be found on the Tax Innovation Center's Homepage. Please note that toolkit items may be updated and improved and new items added periodically. Tax professionals should check the [Tax Innovation Center's Homepage](#) for the most recent versions of toolkit documents.

Solution Profile

An S-Corporation Charitable Contribution Strategy engagement will generally include the following components:

- Benefit Analysis – KPMG will assist the client in analyzing the potential benefits of implementing the strategy.
- Implementation – KPMG will assist the client, the client's legal counsel, and an outside valuation firm in implementing the strategy.

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 361

Tax Solution Alert
 FY00-28
 Page 2

- Tax-Exempt Organization – KPMG will advise the shareholders relative to selection of an appropriate tax-exempt organization to receive the charitable contribution.
- Tax Opinion – KPMG will issue a tax opinion on the strategy.

NOTE: For S corporations with at least one shareholder that is either a Qualified Subchapter S Trust (QSST) or an Electing Small Business Trust (ESBT), the charitable contribution deduction may not be available to the trust shareholder. However, if the QSST or the ESBT owns only a very small portion of the S corporation, the strategy may still be appropriate for that S corporation. You should discuss your particular situation with a member of the National Deployment Team or an appropriate resource within Washington National Tax prior to introducing S-Corporation Charitable Contribution Strategy to your client or target.

Recent Success Stories

S-Corporation Charitable Contribution Strategy has been successfully implemented for several clients in a variety of industries. The strategy was implemented by a homebuilder for a fee of \$1.5 million, a real estate company for a fee of \$1 million, and a profitable Dot.com company for a fee of \$2 million.

Optimal Target Characteristics

An optimal target for S-Corporation Charitable Contribution Strategy has the following characteristics:

- S Corporation;
- Less than six shareholders; and
- Greater than \$3 million in projected annual taxable income for the next two years.

S-Corporation Charitable Contribution Strategy may also be delivered to shareholders who want more flexibility in selecting the ultimate beneficiaries of the charitable contributions. Targets for this version of the strategy should have more than \$10 million in annual taxable income.

Typical Buyer

This solution is best marketed to the shareholders or owners directly.

Pricing and Fee Arrangements

S-Corporation Charitable Contribution Strategy engagements are priced on a fixed fee basis. Our

Tax Solution *Alert*
 FY00-28
 Page 3

experience with similar engagements has been that the fixed fee generally has approximated 10 percent of the expected average taxable income of the S Corporation for the two years following implementation. The minimum fee is \$500,000.

To maintain consistency in the pricing and delivery of S-Corporation Charitable Contribution Strategy, a member of the S-Corporation Charitable Contribution Strategy National Deployment Team (identified below) must approve the terms of all engagements.

Coordination with Assurance

For KPMG audit clients, this solution should be discussed with the assurance engagement team to address specific accounting implications to the client. Specifically, there may be disclosure issues for the S-Corp associated with the issuance of nonvoting stock and warrants. The S-Corp should also disclose the terms of the anticipated redemption agreement between the S-Corp and organization receiving the charitable contribution. When the client is not a KPMG audit client, the client should be advised to consult its own auditors to address the financial accounting implications of the solution.

Effect of Tax Shelter Regulations

The IRS has issued temporary and proposed regulations requiring promoters to register confidential corporate tax shelters and maintain a list of investors, and requiring corporate taxpayers to disclose transactions that possess certain characteristics common to corporate tax shelters. To enable the firm to be in a position to comply should a determination be made that an engagement involving this solution is subject to the new investor list and record retention requirements, an Engagement Information Form (EIF) must be completed for each engagement involving this solution for which we reasonably expect to receive fees of \$25,000 or more. For further information, see Tax Professional Practice Letter (TPPL) 00-08. TPPL 00-08, the EIF, and the EIF instructions are available on the [Department of Professional Practice-Tax Homepage](#).

Service Delivery

S-Corporation Charitable Contribution Strategy is marketed and delivered by a National Deployment Team comprised of professionals from the federal tax and Personal Financial Planning practices. Members of the National Deployment Team are (to contact a team member via Outlook, click on his or her name):

National			
Andrew Atkin	Senior Manager, Federal Tax, National Deployment Champion	Los Angeles	(213) 955-8830
Larry Manth	Partner, Federal Tax	Los Angeles	(213) 630-8101
Robert Huber	Senior Manager, Federal Tax	Los Angeles	(213) 630-5378

Tax Solution Alert
FY00-28
Page 4

<u>Doug Duncan</u>	Senior Manager, Federal Tax	Los Angeles	(213) 630-5376
Northeast			
<u>John Schrier</u>	Partner, Federal Tax, Area Deployment Champion	New York	(212) 872-5906
<u>Tim Speiss</u>	Partner, PFP, Area Deployment Champion	Philadelphia	(215) 299-5053
Midatlantic			
<u>Larry Silver</u>	Partner, Federal Tax, Area Deployment Champion	Philadelphia	(215) 299-3119
<u>Jim Duty</u>	Partner, PFP, Area Deployment Champion	Richmond	(804) 697-4210
Southeast			
<u>Council Leak</u>	Partner, Federal Tax, Area Deployment Champion	Charlotte	(704) 371-8135
<u>Mike Gray</u>	Partner, PFP, Area Deployment Champion	Raleigh	(919) 664-7130
Southwest			
<u>Mike Terracina</u>	Partner, Federal Tax, Area Deployment Champion	Houston	(713) 319-2293
<u>Carol Warley</u>	Partner, PFP, Area Deployment Champion	Houston	(713) 319-2180
Midwest			
<u>Bob Pence</u>	Partner, Federal Tax, Area Deployment Champion	Cleveland	(216) 875-8375
<u>David Cohen</u>	Partner, PFP, Area Deployment Champion	Chicago	(312) 665-5292
West			
<u>Mark Hutchison</u>	Partner, Federal Tax, Area Deployment Champion	Warner Center	(818) 227-6904
<u>Rich Wise</u>	Partner, PFP, Area Deployment Champion	Sacramento	(916) 554-1135

Assessment of Competition

Key Competitors:

Although we believe that the other Big Five and law firms have the ability to deliver similar services, we are not aware of another firm that has developed such a solution.

Toolkit Documents

Tax Solution Alert
FY00-28
Page 5

The solution toolkit that has been created to assist you with marketing and delivering S-Corporation Charitable Contribution strategy engagements is available through TSA FY 00-28 found on the Tax Innovation Center's Homepage. The toolkit contains the following item:

- Internal Solution Overview Presentation

Additional toolkit items are available only to members of the S-Corporation Charitable Contribution Strategy National Deployment Team.

Action Required by the Client Service Professional

An initial target list for S-Corporation Charitable Contribution Strategy has been provided to all tax partners. Please consult the initial target list to identify those companies with which you have a relationship. If you have a relationship with a target or are aware of other clients and targets that fit the S-Corporation Charitable Contribution Strategy target profile, please contact one of the National Deployment Team members named above to discuss action steps for introducing S-Corporation Charitable Contribution Strategy.

Distribution:

U.S. Partners
Assurance Senior Managers and Managers
All Tax Professionals

***Tax Solution Alert* is a periodic publication of KPMG's Tax Practice and is edited by Mark A. Springer, Partner-in-Charge, and Marsha Peters, Partner, of the Washington National Tax - Tax Innovation Center. For more information on KPMG's tax solutions, visit the Tax Innovation Center's Homepage at <http://taxkm.us.kworld.kpmg.com/homepages/tic/index.htm>.**

The information contained in *Tax Solution Alert* is general in nature. Any technical discussion is based on authorities that are subject to change. The reader is responsible for evaluating and determining the applicability of the information contained herein to specific facts and situations. Additional due diligence to assess the viability of any strategy, issue, or opportunity presented in *Tax Solution Alert* is required.

KPMG Peat Marwick LLP

PFP

To: CaTS Team Members

Date: July 1, 1998

From: Gregg Ritchie/Jeffrey C. Zysik

Steno: jcZ

Ref: p:\users\stuffer\wp\jzysik\produ
cts\pfp\opis\confFee.doc

OPIS Engagements - Prohibited States

In order to avoid the appearance of noncompliance with State Accountancy rules, OPIS engagements will not be provided in States whose accountancy rules prohibit contingent fees. The following States rules prohibit contingency fees:

Alaska	Connecticut	District of Columbia
Florida	Hawaii	Idaho
Louisiana	Maryland	Mississippi
Montana	Nebraska	New Hampshire
New Jersey	New Mexico	Puerto Rico
Rhode Island	South Carolina	Virginia
Washington	West Virginia	

If you have an OPIS candidate resident in one of the above jurisdictions, then:

- 1) The engagement letter cannot be *signed* in that jurisdiction, and must be *signed* in a jurisdiction that does not prohibit contingency fees;
- 2) The engagement cannot be managed in that jurisdiction, and must be managed from a jurisdiction that does not prohibit contingency fees; *and*
- 3) The largest amount of services under the engagement must be performed in a jurisdiction that does not prohibit contingency fees.

Provided all of the above requirements are met, and the client is neither an audit client nor a person in a position of significant influence over an audit client, the engagement may be accepted, subject to DPP-Tax approval.

You should also be reminded that OPIS engagement letters must be approved by DPP - Tax prior to their presentment to the client.

Any questions regarding the content of this memo should be directed to Gregg Ritchie (818)227-6905, Mark Watson (214)754-2232, Larry DeLap (650)404-5352, or Jeff Zysik (202)739-8659.

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 363

KPMG 0011954

From: Eischeid, Jeffrey A
 Sent: Tuesday, May 16, 2000 8:34 AM
 To: Napier, Angie; Henderson, Tracie K
 Subject: RE: B&W fees and generic FLIP rep letter

Thanks!

-----Original Message-----

From: Napier, Angie
 Sent: Monday, May 15, 2000 5:33 PM
 To: Eischeid, Jeffrey A; Henderson, Tracie K
 Subject: B&W fees and generic FLIP rep letter

Brown & Wood fees:

Quadra OPIS98 - 30 bpts
 Quadra OPIS99 - 30 bpts

Presidio OPIS98 - 25 bpts
 Presidio OPIS99 - 25 bpts
 BLIPS - 30 bpts

The Presidio amounts are per Kerry. The Foreign entity or the Fund paid the B&W fees on Presidio transactions. I had documentation on Quadra transactions since B&W would send the bill directly to the client and send us a copy too.

Tracie- Attached is the generic FLIP representation letter per your request.

Let me know if you need anything else.

<< File: FLIP00 TEMPLATE REP LETTER.DOC >>

Angie Napier
 Personal Financial Planning
 kpmg LLP
 Phone: (404) 614-8602
 Fax: (404) 222-3435
 anapier@kpmg.com

Our conclusions are limited to the conclusions specifically set forth herein and are based on the completeness and accuracy of the above-stated facts, assumptions and representations. If any of the foregoing facts, assumptions or representations is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986, as amended, the regulations thereunder, and the judicial and administrative interpretations thereof. These authorities are subject to change, retroactively and/or prospectively, and any such changes could affect the validity of our conclusions. We will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

The information in this email is confidential and may be legally privileged. It is intended solely for the addressee. Access to this email by anyone else is unauthorized.

If you are not the intended recipient, any disclosure, copying, distribution or any action taken or omitted to

1

Proprietary Material
 Confidentiality Requested

KPMG 0036342

Permanent Subcommittee on Investigations
 EXHIBIT #155 - FN 364

3849

be taken in reliance on it, is prohibited and may be unlawful. When addressed to our clients any opinions or advice contained in this email are subject to the terms and conditions expressed in the governing KPMG client engagement letter.

3850

Unknown

From: DeLap, Larry
Sent: Thursday, February 11, 1999 3:44 PM
To: Zysk, Jeffrey C; Elgin, Evelyn
Cc: Springer, Mark A; Escheid, Jeffrey A; Watson, Mark T; Becker, Charles J
Subject: RE: BLIPS

Jeff -

Can you prepare a summary or chart of the transactions. Apparently, the investor ends up with a lot higher basis in the distributed financial instruments than their value, but the flow of cash is not immediately clear to me.

... the second bullet of the overview memorandum, the investors "borrows" \$100 million, but actually receives \$150 million in cash, which gets invested in the partnership, with the partnership assuming the liability.

In the fifth bullet, the partnership repays the \$100 million loan to the bank.

As the \$50 million "premium" contemplated a seven year term, but the loan has been paid off within a few months, it would appear the bank has been screwed out of about \$50 million, but I can't believe that will happen. Where does the extra \$50 million go in between the second and fifth bullets.

The opinion letter contains an "overview of investment strategy" that appears to be our view. I think we should say something like "Investment Advisor has provided the following overview of the investment strategy".

We may need an alliance form for Sentinel Advisors. That can take a while to complete and get approved.

The opinion letter refers to transactions with Deutsche Bank. If the transactions will always involve Deutsche Bank, we could have an independence issue. Has a financial institution and an investment bank that are not attest clients been lined up as potential participants that the investor could choose rather than Deutsche Bank or Deutsche Morgan Grenfell? (That is, will the investor be able to freely choose participants who are not attest clients of KPMG?)

It appears that GAAP is an important part of the overall plan. If so, the transaction will need to be reviewed by DPP. Assurance from an accounting standpoint, which could take a while.

Larry

-----Original Message-----
From: Zysk, Jeffrey C
Sent: Thursday, February 11, 1999 6:02 PM
To: DeLap, Larry; Elgin, Evelyn
Cc: Springer, Mark A
Subject: BLIPS

Eve and Larry,

Following are documents relating to a message you are both about to receive. While I realize neither of you volunteered, you both seem like the logical choice (you will understand when you see the attachment to my subsequent message). Please let me know if you delegate to someone else. Eve, I will drop hard copies of these materials at your office later tonight.

Thanks,

Jeff

<< File: blips dpp 2.9.doc >> << File: BLIPS Summary res.doc >> << File: BLIPS Picture ppt4.ppt >>

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 373

KPMG 0037992

3851

Sequential

From: DeLap, Larry [ldelap@KPMG.COM]
Sent: Wednesday, April 28, 1999 11:07 AM
To: Seiden, David M
Cc: Guinan, John M; Trott, Edward W; Allen, Catherine; Bielstein, Mark M
Subject: RE: BLIPS

David -

Yes, the relationship with Presidio has not changed from last summer and yes, I will send the revised engagement letter back by you.

Larry

> -----Original Message-----
> From: Seiden, David M
> Sent: Wednesday, April 28, 1999 10:13 AM
> To: DeLap, Larry
> Cc: Guinan, John M; Trott, Edward W; Allen, Catherine; Bielstein, Mark M
> Subject: RE: BLIPS
>
> Larry
>
> Sorry for the delay. I chatted with John and he asked that I confirm with
> you that our arrangement with Presidio has not changed since last
> reviewed. If that is the case, I have no objections from an independence
> point of view. Will you send this one along again when the engagement
> letters are completed?
>
> David
>
> Larry
>
> Because of the history of Presidio and Deutsche bank from last year,
> before I got involved very much, I want to run this by John. I missed him
> today and will not be able to get to him before Monday. Sorry for any
> inconvenience.
>
> David
>
> David M. Seiden, Partner
> NSS-DPP
> 212.909.5546
> 212.909.5599 fax
> 280 Park Avenue
> New York, NY 10017
>
> -----Original Message-----
> From: DeLap, Larry
> Sent: Tuesday, April 20, 1999 8:43 AM
> To: Seiden, David M; Bielstein, Mark M
> Cc: Guinan, John M; Trott, Edward W; Allen, Catherine; Lashley,
> Carole L
> Subject: BLIPS
>
> << File: Blips investment strategy (8).doc >> << File: BLIPS DPP
> RSB.DOC >> << File: BLIPS.PPT >>
>
> The strategy described in the attachments has not yet cleared
> technical review. Among other things, the wording of the first few pages
> of the draft hypothetical opinion letter will be revised to make it clear
> that declarative statements about the investment strategy are those of the

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 373

KPMG 0011737

3852

> Investment Advisor, not of KPMG.
>
> If approved, the strategy will be marketed only to high wealth
> individuals. Thus, it will not be marketed to any KPMG SEC audit clients.
> Wording of a proposed engagement letter is in process.
>
> The draft opinion, in connection with a loan transaction that is at
> the heart of the strategy, has parenthetical references to Deutsche Bank,
> a KPMG audit client. Last year, a different tax strategy promoted in
> conjunction with the same investment advisor (with whom a Level I alliance
> has been approved) involved investments in Deutsche Bank securities. That
> raised independence issues relative to Deutsche Bank, which issues were
> resolved by having the investment advisor find nonaudit client banks who
> were willing to participate in that program and offering investors a
> choice of which bank's securities to invest in. In the instant case, the
> intent is for the investor in the new program to be offered a choice of at
> least three banks (including Deutsche Bank) with whom to enter into the
> borrowing program, of which at least one bank will be a nonaudit client.
> It has been assumed that, similar to last year's determination, the
> availability of a choice to the investor will avoid any independence issue
> relative to Deutsche Bank. Please confirm.
>
> The second paragraph of the section headed "Debt Instruments - The
> General Rules" has a discussion of financial accounting. Please confirm
> whether that discussion is accurate. There is no need for you to read the
> rest of the technical discussion in the draft opinion.
>
> Larry

3853

Message0030	
Subject:	FLIPS/OPIS/BLIPS Attorney Referrals
From:	Collins, Erin M
Date:	4/9/2002 1:51:08 PM
To:	Paule, Robin M; Hasting, Carl D; Baumann, Dale R; Rivkin, David; Mccrimlisk, George H; Carbo, Deke G; Pace, Kevin A
CC:	Afonso, Dale A
Message Body	
<p>This is a list that our group put together. All of the attorneys are part of the coalition and friendly to the firm. Feel free to forward to a client if they would like a referral.</p> <p>Erin M. Collins Tax Controversy Services erncollins@kpmg.com tel 213-955-8568 fax 213-955-8650 kpmg</p>	
Attachment	
Attorney List.doc	

Outlook Header Information
Conversation Topic: Attorneys
Subject: FLIPS/OPIS/BLIPS Attorney Referrals
From: Collins, Erin M
Sender Name: Collins, Erin M
To: Paule, Robin M; Hasting, Carl D; Baumann, Dale R; Rivkin, David; Mccrimlisk, George H; Carbo, Deke G; Pace, Kevin A
CC: Afonso, Dale A
Received By: Baumann, Dale R
Delivery Time: 4/9/2002 1:51:08 PM
Creation Time: 4/10/2002 8:49:03 AM
Modification Time: 4/10/2002 8:49:04 AM
Submit Time: 4/9/2002 1:51:06 PM
Importance: 4/1
Priority: 4/0
Sensitivity: 4/0
Flags: 4/17
Size: 4/48038

Proprietary Material
Confidentiality Requested

Permanent Subcommittee on Investigations
EXHIBIT #155 - FN 383

KPMG 0050113

**Memorandum**

November 14, 2003

TO: Senate Governmental Affairs Committee; Permanent Subcommittee on Investigations
Attention: Laura Stuber

FROM: Jack Maskell
Legislative Attorney
American Law Division

SUBJECT: Attorneys and Potential Conflicts of Interest Between New Clients and Existing Clients

This memorandum responds to the subcommittee's request, as discussed with Laura Stuber, for a brief examination of the conflicts of interest issues that may exist for a private attorney who represents an individual client in a matter which may eventually conflict directly with the legal interests of another, institutional client of the attorney or of the attorney's firm.

The facts involve generally the purchase of a "tax product," such as a tax shelter, by an individual from an accounting firm. The Internal Revenue Service apparently rejected the legitimacy or efficacy of the tax shelter, and the individual apparently retained the attorney initially to pursue the matter before the Internal Revenue Service and/or in litigation in appeal of the I.R.S. ruling. The attorney, or the attorney's firm, also represented at the same time, however, the accounting firm which provided the tax shelter to the client, and when the individual taxpayer was unsuccessful in challenging the Internal Revenue Service ruling, and wished to pursue his rights against the accounting firm for selling him a defective "tax product," the attorney explained that he may not represent the individual in that matter since he or his firm also represents the accounting firm. The attorney apparently provided a general statement or disclaimer upon initial retention that the attorney or firm also represents certain "big five" accounting firms. The question has been presented as to whether the attorney should have rejected the initial representation of the individual taxpayer because of the existing or the potential for a conflict of interest between the interests of the individual taxpayer and the accounting firm.

The general conflict of interest rule for attorneys promulgated within the Model Rules of Professional Conduct by the American Bar Association, and adopted within the various jurisdictions, notes that an attorney should not represent a client "if the representation involves a concurrent conflict of interest," absent an informed consent in writing from the

Congressional Research Service Washington, D.C. 20540-7000

Permanent Subcommittee on Investigations

EXHIBIT #155 - FN 385

affected clients.¹ A “concurrent conflict of interest,” notes the Rule, exists when “the representation of one client will be directly adverse to another client.”² Even when there is no *immediate* conflict or immediate adverse interest, the American Bar Association Rules provide that where there is a “significant risk” that a conflict of interest may arise where the interests of an existing client will “materially limit[]” the attorney’s ability to represent or to pursue a particular course of action for the new client during representation, then the attorney should decline the employment unless, again, there is an informed written consent for the representation despite the potential conflict.³ ABA Model Rule 1.7 provides, in relevant part, as follows:

Rule 1.7

Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client;
or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

The ABA Model Rule at 1.7(b)(3) indicates that when a concurrent conflict of interest exists in a representation which involves the “assertion of a claim by one client against another client” of the attorney in the same litigation or proceeding, that such a conflict is so obvious and contrary to the advocacy/adversarial principles of legal representation that it may not be waived. In the fact situation under consideration, there is not necessarily a current or immediate conflict of this nature, as the original action was apparently litigation or representation involving the Internal Revenue Service determination on the legitimacy of the tax shelter, and in such case there was a concurrence, rather than a conflict, of interest between the two clients. However, was there either a present conflict of interest because the “representation of one client will be directly adverse to another client” (1.7(a)(1)), or a foreseeable and “significant risk” that the relationship with an existing client could materially limit the attorney’s representation of the new client (1.7(a)(2)), such that the attorney should

¹ American Bar Association [ABA], Model Rules of Professional Conduct, Rule 1.7. The specific wording and application of the Rule will depend on the particular jurisdiction in which the attorney is licensed, and the jurisdiction’s adoption of the Model Rule or similar language. Rule 1.7 was amended by the ABA in 2002, although “no change in substance” was intended. ABA, Center for Professional Responsibility, Reporter’s Explanation of Changes, Model Rule 1.7, paragraph 1.

² *Id.* at Rule 1.7(a)(1).

³ *Id.* at Rule 1.7(a)(2).

have declined the representation of the individual taxpayer in the first place because of his or his firm's representation of the institutional client?⁴

Under the ABA Rule there would appear to be a "significant risk" that the representation of one client (the individual taxpayer in the case under consideration) "will be materially limited by the lawyer's responsibilities to another client" (the accounting firm), if the attorney would not be able to exercise the full range of representational and litigation options for the private taxpayer because of his, or his firm's, representation of the institutional client.⁵ The "general principles" concerning this Rule discussed by the American Bar Association, provide as follows:

Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or *carry out an appropriate course of action for the client* will be materially limited as a result of the lawyer's other responsibilities or interests. For example, a lawyer asked to represent several individuals seeking to form a joint venture is likely to be materially limited in the lawyer's ability to recommend or advocate all possible positions that each might take because of the lawyer's duty of loyalty to the others. The conflict in effect forecloses alternatives that would otherwise be available to the client. The mere possibility of subsequent harm does not in itself require disclosure and consent. The critical questions are the likelihood that a difference in interest will eventuate and, if it does, whether it will materially interfere with the lawyer's independent professional judgment in considering alternatives or foreclose courses of action that reasonably should be pursued on behalf of the client.⁶

There are several reasons for the enactment of this conflict of interest rule, not the least of which is that an attorney needs to exercise "independent judgment" on behalf of a client,⁷ and that such judgment as to the best interests of a *new* client may be compromised when there exists the possibility that the legal options for the new client may include an action adverse to the interests of an *existing* client, that is, that this new client may at some point need to proceed against an existing client of the attorney's or the attorney's firm. The ABA has noted that representation of a new client should be declined when the duty owed an existing client "was likely to impair the independence of judgment or the zeal that the lawyer could bring to bear on behalf" of the new client.⁸ Furthermore, the ABA has explained that "in addition to an evaluation of the likelihood that the conflict will eventuate, the appropriate inquiry is whether it would materially interfere with the lawyer's independent professional judgment in considering alternatives, or *foreclose courses of action that reasonably should*

⁴ See general imputation rule for conflicts of interest of lawyers "associated in a firm," at Rule 1.10.

⁵ ABA Formal Ethics Opinion 95-390, at 4 (1995). "Where the new representation will be materially limited by the lawyer's responsibility to an existing client, the new representation is prohibited"

⁶ American Bar Association, Center for Professional Responsibility, *Annotated Model Rules of Professional Conduct*, 5th Edition, Rule 1.7, General Principles, paragraph 8, at p. 109 (2003).

⁷ *Id.*, General Principles, paragraph 1, at p. 107. Note former ABA *Model Code of Professional Responsibility*, at Canon 5, "A Lawyer Should Exercise Independent Professional Judgment on Behalf of a Client," and EC 5-1: "The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client."

⁸ ABA Formal Ethics Opinion 95-390, *supra* at 4, 14.

*be pursued on the client's behalf.*⁹ Thus, the decision to proceed initially, for example, to challenge the Internal Revenue Service ruling on the tax shelter matter, rather than to proceed directly against the accounting firm providing the disputed tax shelter to the new client, might possibly be influenced, or could be perceived to be influenced by the attorney's relationship and required loyalty to that accounting firm as an existing client. As noted by the ABA, "the touchstone of the Rule ... is loyalty to the client," and that "[d]isloyalty is easily perceived by a client"¹⁰ Additionally, the conflict rule exists because there may be confidential information to which the attorney is privy based on his or his firm's representation of the other client, the accounting firm, or eventually because of his representation of the individual taxpayer, which may be detrimental to one or the other clients. Finally, the necessity to decline to represent the new client against the existing client in subsequently needed litigation will obviously cause additional hardship and expense for the new client in obtaining new counsel and paying for that new attorney's time to get up to speed on the legal matters involved.

The possibility that the litigation involving the Internal Revenue Service ruling could be unsuccessful, either before the I.R.S. or in court upon appeal of the I.R.S. ruling is, of course, one that is real and distinct, and could not fairly be described as merely a remote possibility or one based on unreasonable speculation (particularly since the I.R.S. had apparently already made an initial ruling against the efficacy of the particular tax shelter). The original option of litigation against the accounting firm instead of, or concurrently with, litigation involving the Internal Revenue Service, as well as the eventual option and obvious possibility of litigating against the accounting firm if and when the litigation involving the I.R.S. was unsuccessful, thus clearly and naturally existed, and was not merely an "unforeseeable development[]"¹¹ in the course of the attorney's representation of the individual taxpayer.

The attorney in question under ABA rules could *not* litigate for the individual taxpayer against the accounting firm either at the time of *initial* employment, or later as a reasonably foreseeable consequence of unsuccessful legal action involving the Internal Revenue Service's original decision, and *that* conflict of interest could not be waived.¹² As such, the attorney's ability to "carry out an appropriate course of conduct" for the individual taxpayer appeared to be "materially limited" and compromised, in other words, the existing client relationship with the accounting firm "foreclose[d] courses of action that reasonably should be pursued on the [new] client's behalf" (litigation against or pursuing a settlement with the accounting firm), and an informed consent and waiver of that existing conflict should have been obtained prior to representing the individual taxpayer.

The potential conflict of interest in the initial legal actions concerning the Internal Revenue Service ruling may arguably have been able to have been waived with a knowing and informed consent of the clients, made in writing.¹³ The waiver and consent required of the new client was, however, not merely a blanket disclosure that the firm represented the accounting firm in question. Rather, an "informed consent" as required by the ABA rules

⁹ *Annotated Model Rules of Professional Conduct, supra* at 120. Emphasis added.

¹⁰ *Id.* at 15.

¹¹ *Annotated Model Rules of Professional Conduct, supra* at 108, General Principles, paragraph 5.

¹² Rule 1.7(a) and (b)(3).

¹³ Rule 1.7(b)(4).

requires a “full disclosure of the *nature and implications* of the lawyer’s conflict.”¹⁴ Information necessary for the new client to understand the potential for the conflict of interest, and that such conflict would prevent the attorney from representing the new client/individual taxpayer’s interests against the accounting firm that provided the defective tax shelter to him, would appear to have been required by the ABA Rule. Even under the older version of Rule 1.7, where only “consent after consultation” was required, such consultation required “communication of information reasonably sufficient to permit the client to appreciate the significance of the matter in question.”¹⁵ The new version of the ABA Rules adopted in 2002 substitutes “informed consent” for “consent after consultation” to increase the burden and requirement of full explanation of the potential conflict.¹⁶ The ABA has explained in its Comments to the Rule:

One condition necessary for curing an otherwise impermissible conflict is that the client give informed consent, after full disclosure of the nature and implications of the lawyer’s conflict. Informed consent denotes the client’s agreement to the lawyer’s proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of – and reasonably available alternatives to – the proposed course of conduct. See *Model Rules of Prof’l Conduct*, R. 1.0(e), R. 1.7 cmt. [18] (2002). For one court’s identification of requirements for an effective waiver, see *In re Guardianship of Lillian P.*, 617 N.W.2d 849 (Wis. Ct. App.) (knowing and voluntary waiver of conflict or potential conflicts in representation, nature of conflicts or potential conflicts in relationship to lawyer’s representation of client’s interest, and fact that exercise of lawyer’s independent professional judgment could be affected by lawyer’s own interests or those of another client; on client’s part, effective waiver requires understanding of conflicts or potential conflicts and how they could affect lawyer’s representation, understanding of risks inherent in representation, and ability to choose other representation), *review denied*, 619 N.W.2d 93 (Wis. 2000).¹⁷

¹⁴ *Annotated Model Rules of Professional Conduct*, *supra* at 135. Emphasis added.

¹⁵ ABA Formal Ethics Opinion 95-390, *supra* at 4, citing Model Rules, Terminology.

¹⁶ ABA, Center for Professional Responsibility, Reporter’s Explanation of Changes, Model Rule 1.7, paragraph 3.

¹⁷ *Annotated Model Rules of Professional Conduct*, *supra* at 135.